STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **THE SHERWIN-WILLIAMS COMPANY** for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1987, 1989, 1990 and 1991.	: : : : :	DETERMINATION DTA NO. 816712

Petitioner, The Sherwin-Williams Company, 101 Prospect Avenue, N.W., Cleveland, Ohio 44115, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1987 through 1991.

A hearing was held before Winifred M. Maloney, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, that commenced on June 29 and 30, 1999, July 1 and 2, 1999, continued on July 15 and 16, 1999 and July 26 through 30, 1999 in Troy, New York and continued until conclusion on September 8 through 10, 1999 in New York, New York, with all briefs to be submitted by September 8, 2000, which date began the six-month period for the issuance of this determination. The six-month period was extended for an additional three months, pursuant to Tax Appeals Tribunal Rules of Practice and Procedure § 3000.15(e)(1). Petitioner appeared by Morrison & Foerster, LLP (Paul Frankel, Esq. and Craig B. Fields, Esq., of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (James Connolly, Esq., and James Della Porta, Esq., of counsel).

ISSUE

Whether the Division of Taxation may require petitioner to file its franchise tax report on a combined basis with SWIMC, Inc. and DIMC, Inc., two of its subsidiaries.

FINDINGS OF FACT

Petitioner, The Sherwin-Williams Company ("Sherwin-Williams" or "S-W"), filed a petition protesting a Notice of Deficiency of corporation franchise tax issued by the Division of Taxation ("Division"). Pursuant to section 3000.15(d)(6) of the Rules of Practice and Procedure of the Tax Appeals Tribunal and section 3071 of the State Administrative Procedure Act, each party submitted proposed findings of fact. The proposed findings of fact have been substantially incorporated into this determination with the exceptions noted in the final finding of fact.

The parties jointly submitted 372 proposed changes to the transcript of hearing. Those changes to the transcript of hearing are hereby accepted.

1. As a result of a corporation franchise tax field audit, the Division, on January 13, 1997, issued a Notice of Deficiency (Notice No. L-013066163-1) to petitioner asserting additional corporation franchise tax due in the amount of $196,536.00, plus interest, for a total amount due of $296,682.72 for the years 1987 through 1991, except for 1988.

2. On August 31, 1998, a petition was filed challenging the assertion of additional corporation franchise tax. The petition asserts that the Division erred in requiring petitioner to file a combined corporation franchise tax report with two of its affiliates, SWIMC, Inc. ("SWIMC") and DIMC, Inc. ("DIMC") for the year 1991. It also asserts that the Division erred in including certain royalty income received by petitioner in the computation of its entire net income base for the years 1989 through 1991. The issue concerning the royalty income is no longer in dispute.

Corporate History

3. Petitioner, incorporated under the laws of Ohio in 1884, has its principal place of business and commercial domicile in Cleveland, Ohio. It is engaged in the manufacture, distribution and sale of coatings, e.g., paints and related products, and is one of the largest manufacturers of paints and varnishes. Petitioner sells architectural coatings, industrial finishes and associated supplies through company-operated paint and wall covering stores under the label "Sherwin-Williams." It manufactures and sells coatings under other brands including, but not limited to, "Dutch Boy," "Martin-Senour," "Dupli-Color" and "Krylon," plus private label brands to independent dealers, mass merchandisers and home improvement centers. Sherwin-Williams also produces coatings for original equipment manufacturers ("OEM") in a number of industries and special purpose coatings for the automotive aftermarket, industrial maintenance and traffic paint markets.

4. Although Sherwin-Williams has developed many products over the years, it also has a long history of acquiring product lines and paint facilities. Sherwin-Williams' acquisitions, among others, include: the 1917 acquisition of the Martin-Senour Company of Chicago, a well-known maker of premium paints; the 1920 acquisition of Acme Quality Paints, Inc. of Detroit, a multi-million dollar business specializing in coatings for the carriage and automobile industries; the 1966 acquisition of Sprayon Products of Ohio, a well-established aerosol packager specializing in spray paint; the 1980 acquisition of the "Dutch Boy" brand and paint facilities; the 1984 acquisition of Dupli-Color Products Company, specializing in automotive aftermarket

paints and the 1990 acquisitions of Borden, Inc.'s "Krylon" and "Illinois Bronze" aerosol paint operations and De Soto, Inc.'s architectural coatings business.[1]

5. In addition to acquisitions, over time Sherwin-Williams expanded its own operations by either building or modernizing manufacturing plants as necessary. Although acquisitions and capital expansion helped fuel Sherwin-Williams' successful growth in the coatings industry, it also created a debt-ladened company which, in 1977, reported a loss and was unable to pay a dividend for the first time in its history.

6. In January 1979, with bankruptcy looming, John G. Breen was hired to turn Sherwin-Williams around. Upon becoming Sherwin-Williams' President and Chief Executive Officer, Mr. Breen hired a new management team consisting of Conway G. Ivy, who became Vice President of Corporate Planning and Development, and Thomas A. Commes, who became Senior Vice President of Finance.

Although none of these individuals had any knowledge about the paint business, they brought strong management skills to Sherwin-Williams. Mr. Breen and his new management team immediately began changing the Sherwin-Williams corporate culture. They held monthly meetings with all top executives to review operations. Managers were required to submit detailed written plans that explained the nature of their businesses, including products, strengths, weaknesses, competitors and future plans. Every division began to submit annual operating plans from which Sherwin-Williams developed comprehensive policies that included budgeting, strategic planning and management assessment. Top executives and division managers actively participated in strategic planning and budgeting meetings. Mr. Breen made it clear that he did

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[1] De Soto, Inc., which traced its roots back to 1910 as one of the largest paint manufacturers in the United States, supplied private label paints to chains such as Sears and Home Depot.

not expect to run Sherwin-Williams from the top down. Rather, the authority to set goals and the responsibility to meet them was delegated to people lower in the Sherwin-Williams hierarchy. Division managers were held directly accountable for their performance. Decentralization proceeded further by converting Sherwin-Williams' nine domestic divisions into profit centers, and by installing a rigorous management accounting system that charged the divisions for the use of working capital and fixed assets.

7. On the same day that Mr. Breen became president of Sherwin-Williams, Gulf and Western notified the Securities and Exchange Commission that it planned to purchase 25% of Sherwin-Williams stock. The threat of a hostile takeover by Gulf and Western was on the minds of the new management team as they began the task of turning S-W around. The success of the new management and cash management practices initiated under Mr. Breen's leadership was immediate. Sherwin-Williams was able to repurchase the shares held by Gulf and Western in late 1979.

8. Petitioner has always used trademarks, trade names and service marks (collectively "Marks") in conducting its business. The Marks included the "Sherwin-Williams" brand, registered on April 20, 1948, various "Cover the Earth" logos , the first one registered in 1906, several "Dutch Boy" trademarks, the first one registered on March 5, 1918, "Protecting the American Dream" a common law trademark and "The Look that Gets the Look" slogan, that was filed on March 2, 1990, to name just a few.

9. Under Sherwin-Williams' decentralized operating autonomy, the management of Sherwin-Williams' trademarks was handled at the divisional level. Although decentralization of Sherwin-Williams was good for its operations, decentralization of the authority to control and use the trademarks among its divisions caused management of the Marks to be diffused and

caused conflicts among the divisions. Often the divisions did not place sufficient focus upon the Marks. Some Marks were used by more than one division. At times the operating divisions forgot that the Marks that they were using were not theirs alone, and those divisions would make changes in the presentation of the Marks as suited their purposes without clearance from Sherwin-Williams' legal department. Changes in the presentation of a trademark can lead to dilution of that trademark. If dilution of a trademark occurs, the owner of the trademark can lose its rights to the trademark. In one instance, the Chemical Coatings Division merged two marks, that merger could have potentially given rise to the dilution of both Marks. Also, the operating divisions did not always alert Sherwin-Williams' legal department about new trademarks they were using, causing a delay in federal registrations. Sometimes, without notifying the legal department, divisions discontinued using trademarks that might have been useful to other divisions of the company. Trademarks are deemed abandoned when they are not used and there is an intent to abandon their use.

10. In 1983, while in the process of structuring a joint venture with C-I-L Inc., a Canadian company, Mr. Ivy selected "Canada Paint," a trademark from a partial list provided by Sherwin-Williams' legal department as the name for the joint venture. He was informed that the name "Canada Paint Company" could not be used. At that time, it was discovered that the "Canada Paint" mark had not been used in Canada for over 20 years, unbeknown to all at Sherwin-Williams except the division in Canada that had been previously using it. During the 20-year hiatus of non-use another entity began to use the "Canada Paint" name, and Sherwin-Williams' rights in the trademark had been lost. Although Mr. Ivy did voice his concerns about how Sherwin-Williams' trademarks were being managed and the need for better organization so that trademarks would not be lost, those concerns were not addressed at that time.

11. Decentralization also made it difficult to reach a consensus regarding third-party licensing. Although Sherwin-Williams had a number of foreign third-party licenses prior to 1991, it had only one domestic third-party license. Moreover, that sole license was not entered into by Sherwin-Williams, but was the result of its acquisition of another company that had entered into the license.

12. The authority to manage, control and use Sherwin-Williams' patents was also delegated to the divisions. However, because the patents were usually used by one division, Sherwin-Williams had not experienced any problems with their management.

Creation Of SWIMC, Inc. and DIMC, Inc.

13. Mr. Robert E. McDonald, admitted as an expert in intellectual property law, is a chemist and a trademark and patent attorney who has been employed by Sherwin-Williams since 1971.[2] During 1990 and 1991, he was petitioner's Senior Corporate Counsel of Patents and Trademarks. Currently, he is the Associate General Counsel of Patents and Trademarks.

14. In mid-1990, an idea for the more efficient management of petitioner's Marks - - the creation of separate corporations, SWIMC and DIMC, to be incorporated in Delaware to hold and manage the Marks -- was presented to Mr. McDonald by Steven Tan, a former attorney in petitioner's intellectual property office, and David Cummings, petitioner's Manager of Tax Planning and Special Projects. The idea was also presented to and discussed with, among others, petitioner's Chief Financial Officer, Thomas Miklich, and General Counsel, Larry J. Pitorak.

15. The creation of one or two new divisions to manage the trademarks was not considered feasible because of Sherwin-Williams' corporate culture of decentralized operating

[2] Mr. McDonald is also an inventor who holds two American patents and one Canadian patent in his own name.

autonomy. The formation of two corporations was considered because of various environmental and legal issues related to the use of aerosol products. Segregating the aerosol-related Marks into a separate corporation would enable Sherwin-Williams to separately track aerosol sales, something it was unable to do at that time.

16. Mr. McDonald had neither seen any promotional materials for the creation of trademark holding companies in Delaware, nor read any articles “touting” the tax benefits of forming Delaware holding companies when he began considering whether separate trademark companies should be formed.

17. At the time that the formation of SWIMC and DIMC was under consideration, concerns were expressed regarding the separation of the Marks from Sherwin-Williams and the risk that the separation might be considered a “naked assignment” or “naked license.” Having a “naked assignment” or “naked license” could result in the loss of the Marks. A “naked assignment” is a transfer of a trademark without its related goodwill. A “naked license” is a transfer of the right to use a trademark without retention of control over the trademark.

18. After research, Mr. McDonald determined that if the assignment of the Marks to SWIMC and DIMC and the license-back of the Marks to petitioner were properly structured and abided by there would be no “naked license” or “naked assignment” problem.

19. Discussions continued, and it was decided that an information gathering trip to Wilmington, Delaware by Sherwin-Williams personnel was necessary for a comprehensive analysis of the benefits that could be realized by creating separate corporations to hold and manage the marks. Meetings were scheduled with various business and legal professionals. During that summer 1990 information-gathering trip, Messrs. McDonald and Cummings met

with bankers and attorneys, including Mr. Gordon Stewart, and also Dr. Donald Puglisi, a Delaware resident with substantial investment management experience.

20. Mr. Stewart and his law firm Duane, Morris & Hecksher ("Duane, Morris") [3] were interviewed by Messrs. McDonald and Cummings regarding Sherwin-Williams' possible engagement of that firm to provide legal services in connection with the formation of two trademark protection corporations. During that interview, other considerations discussed included the advantages in having Delaware as the corporations' commercial domicile.

21. Dr. Puglisi met with Messrs. McDonald and Cummings, in Delaware, during the summer of 1990, regarding the trademark protection corporations that Sherwin-Williams was considering establishing. Prior to that meeting, Dr. Puglisi had sent his *curriculum vitae* to Messrs. McDonald and Cummings. At that meeting, the subject of taxes was not brought up. Rather the discussions focused mainly on Dr. Puglisi's investment management, general management and administrative skills.

22. By that time, Dr. Puglisi already had 18 years experience in managing large investment portfolios and in other administrative aspects of business management. In addition, Dr. Puglisi was a full professor of finance at the University of Delaware. He was also the owner of Puglisi and Associates, Inc. Puglisi and Associates, which employed two associates, provided services as the United States representative for foreign corporations and foreign governments issuing securities in the United States. Puglisi and Associates continues to provide those services. In 1992, Dr. Puglisi became the MBNA America Professor at the University of Delaware, an endowed chair he still holds. In 1997, Dr. Puglisi was appointed by Delaware's

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[3] Duane, Morris is a Delaware law firm. In 1994, Mr. Stewart resigned his partnership position at Duane, Morris and established Stewart & Associates, a professional law association, located in Wilmington, Delaware.

Governor and confirmed by Delaware's Senate as a Commissioner on Delaware's Public Service Commission. He continues to serve as a Commissioner on Delaware's Public Service Commission.

23. Based on the discussions that took place at that meeting, Dr. Puglisi understood that the purposes for forming the corporations were to provide oversight and management of the Marks and to ensure that the royalty income from those Marks was properly invested. In addition to discussing Dr. Puglisi's credentials, hostile takeovers were also discussed and Dr. Puglisi noted that there were potential benefits that forming trademark protection corporations might afford a company faced with a hostile takeover attempt.

24. Upon their return to Cleveland, Messrs. McDonald and Cummings analyzed the information gathered and evaluated the qualifications of the individuals interviewed. After further discussions with, among others, Messrs. Miklich and Pitorak, it was concluded that the creation of SWIMC and DIMC to manage the Marks would alleviate the mark-management problems that Sherwin-Williams had been experiencing. It was also concluded that there were additional benefits in forming SWIMC and DIMC. Those benefits included the benefit of incorporating in Delaware, the ability to use SWIMC and DIMC as possible shields should a hostile takeover attempt ensue, the ability to use SWIMC and DIMC as investment and financing vehicles, tax considerations, the ability to insulate the Marks from the liabilities (general business and environmental) of Sherwin-Williams, increasing focus on third-party licensing, particularly with regard to lesser-known Marks, and limiting Sherwin-Williams' liability with regard to third-party licenses.

25. Delaware sets the national standard for corporate law because of its widely-known provisions. Delaware also has a technologically advanced Secretary of State's office, providing

quick access to filed documents, and is often the jurisdiction of choice for hearing intellectual property matters.

26. Sherwin-Williams was sensitive to the potential threat of a hostile takeover. After the Gulf and Western hostile takeover attempt was thwarted, various investment bankers circulated books on Sherwin-Williams to entice other potential bidders to consider a takeover. In a hostile takeover situation, SWIMC or DIMC stock could be sold to a "white knight." Transferring the stock of SWIMC or DIMC could be done more expeditiously than navigating through the time-consuming process of identifying and then transferring the Marks themselves.

27. Prior to the transfer of the trademarks to SWIMC and DIMC, petitioner's intellectual property office kept a computerized docketing system that tracked information for its trademarks, including the name of the trademark, description of what action was required and when, if it was completed or not and registrations. However, many common law trademarks used by the various divisions were not listed in that docketing system. When it was decided that the domestic Marks should be transferred to SWIMC and DIMC, Sherwin-Williams' legal department reviewed the labels and promotional materials used by each division to ascertain the number of common law trademarks actually being used by the various divisions. It took Sherwin-Williams three to four months to assemble all of the domestic Marks that it transferred to SWIMC and DIMC.

28. Sherwin-Williams invested its cash on an overnight basis. Those short-term investments were conservative in nature and, therefore, did not generate maximum returns. Sherwin-Williams did not have the in-house expertise to improve returns on longer-term investments or to establish flexible financing options. The royalty streams generated by SWIMC and DIMC through the licensing of their respective Marks could be invested in longer-term

investments that generated greater returns. Furthermore, securitization of the royalty income streams to SWIMC and DIMC could be used as an additional source of financing.

29. Third-party licensing was of particular importance for lesser-known Marks that were not being used. Non-use of Marks could cause them to be deemed abandoned. Sherwin-Williams was also concerned about insulating itself from potential claims by third-party licensees, especially the third-party licensing of aerosol-related Marks, such as "Krylon." Aerosols were particularly risky because they were often used by graffiti artists and they could explode if exposed to fire. Individuals also inhaled the aerosol propellant to become "high."

30. Approximately 95% of Sherwin-Williams' sales were domestic. Therefore, it was decided that the initial focus of the restructuring of the management of the Marks should be on the approximately 550 domestic Marks owned by Sherwin-Williams.

31. In the Fall of 1990, Messrs. Miklich, McDonald and Cummings presented the idea for the formation of SWIMC and DIMC to Mr. Ivy. At that meeting, Mr. Ivy was presented with a single-page bullet list of the reasons for creating the two subsidiaries. That list was used by those individuals and Mr. Ivy as a "talking list" in their discussion of each of the reasons for the creation of SWIMC and DIMC. Mr. Ivy did not create a file as result of that meeting and he did not retain a copy of the "talking list." He had seen copies of the "talking list" floating around, but did not know where it was on June 30, 1999, one of the days he testified. At that meeting he agreed to be a director of both SWIMC and DIMC.

Formation of SWIMC and DIMC

32. Once it was determined that the formation of two separate corporations to manage and protect the Marks made good business sense, the decision was made to present the proposal for

the formation of two investment management and trademark protection corporations to Sherwin-Williams' Board of Directors for its consideration.

33. In support of the proposal, Messrs. McDonald and Cummings were involved in the preparation of a business plan which outlined the benefits that could be achieved by the creation of two trademark management and protection corporations. The record includes a copy of the business plan, dated January 18, 1991.[4] The plan lists 11 benefits that would result from establishing SWIMC and DIMC. It also contains a summary of, among other things, the steps necessary for the formation of the two investment management and trademark holding subsidiaries and the various activities and services necessary for the operation of the two subsidiaries. A summary schedule of the estimated costs is also included in the business plan. The business plan does not identify any disadvantages associated with the proposed formation of the two subsidiaries.

34. Louis E. Stellato, then Assistant Secretary and Corporate Director of Taxes, presented the proposal to Sherwin-Williams' Board of Directors whose members included, among others, current or former (retired) chairmen/chief executive officers and current or former (retired) high-level executive officers of various large corporations.

35. On January 23, 1991, Sherwin-Williams' Board of Directors adopted resolutions that would allow for the establishment of two investment management and trademark holding subsidiaries, the assignment of Sherwin-Williams' domestic trademarks, trade names and service marks and all goodwill associated therewith to those subsidiaries and petitioner's nonexclusive licensing back of the transferred Marks in return for the payment of royalties.

[4] A jumbled copy of the business plan is part of the Division's Exhibit "J."

36. The minutes of the January 23, 1991 meeting of Sherwin-Williams' Board of Directors state that the benefits of forming two corporations to hold and manage the Marks are to: (i) improve quality control oversight and increase efficiencies with regard to the Marks by virtue of having profit centers separate from Sherwin-Williams; (ii) provide easier profit analyses of Sherwin-Williams by having profit centers for the Marks which are separate from it; (iii) enhance the ability to enter into third-party licensing arrangements at advantageous royalty rates; (iv) increase overall profitability because of the availability of Delaware's corporate income tax exemption for investment and trademark holding companies; (v) separate and centralize investment management to maximize investment returns associated with the Marks; (vi) provide additional avenues that might be used when acquiring companies; (vii) provide additional financing vehicles; (viii) use the well-developed body of corporate law and expeditious legal system in Delaware; (ix) insulate the Marks from Sherwin-Williams' liabilities; (x) have flexibility in preventing a hostile takeover; and (xi) increase liquidity.

37. It was decided that the two corporations would be named SWIMC, Inc. (for Sherwin-Williams Investment Management Company) and DIMC, Inc. (for Dupli-Color Investment Management Company). SWIMC, the wholly-owned subsidiary, would own the non-aerosol Marks. While DIMC, which would be 85% owned by Sherwin-Williams and 15% owned by Dupli-Color Products Company ("Dupli-Color") (a wholly-owned subsidiary of Sherwin-Williams), would own the aerosol marks.

38. The organizational documents, e.g., certificates of incorporation, Board resolutions of the incorporator, bylaws, agreements regarding capital contributions, license agreements, banking resolutions and stock certificates, were prepared for SWIMC and DIMC by Mr. Stewart.

39. On January 30, 1991, Mr. Stewart, as incorporator, executed two certificates of

incorporation, one for SWIMC, Inc. and the other for DIMC, Inc. Both certificates of incorporation were filed with the Office of Secretary of State of the State of Delaware on January 31, 1991.

40. The purpose and activities of SWIMC and DIMC are set forth in their certificates of incorporation and bylaws. The purpose of SWIMC and DIMC is to engage in any lawful act or activity for which corporations may be organized under Delaware's General Corporation Law. However, the activities of SWIMC and DIMC are confined to the maintenance and management of their respective intangible investments and the collection and distribution of the income from such investments or from tangible property physically located outside of Delaware.

41. The certificates of incorporation of both SWIMC and DIMC, as originally executed, each contain the following Article ELEVENTH:

> The corporation may not lease, sell, exchange, transfer, license, assign (except to affiliates), or dispose of any of the assets of the Corporation (except for assets having a value under $2,000), without the approval of the holders of a majority of shares of the corporation's capital stock issued and outstanding at the time. Nothing in this Article ELEVENTH shall restrict the disbursement of funds from the corporation's accounts with financial institutions as and when approved by the directors in accordance with the bylaws.

42. The certificates of incorporation also provide that SWIMC and DIMC are to have no power and could not be authorized by their stockholders or directors to undertake any activities that would lead them to lose tax exempt status in Delaware or to be subjected to taxation in any other state.

Selection of Directors and Officers

43. John L. Ault, Mr. Ivy and Dr. Puglisi were named to SWIMC's and DIMC's original boards of directors. Mr. Stewart was added as a board member of each corporation shortly after

incorporation. Only two of the four directors appointed to each board, Messrs. Ault and Ivy, were affiliated with Sherwin-Williams.

44. Mr. Ault has been employed by Sherwin-Williams for 23 years and is Vice President and Corporate Controller of Sherwin-Williams, a position he also held in 1991, when SWIMC and DIMC were formed. Mr. Ault heard about the idea of creating SWIMC and DIMC from his superior, Mr. Miklich, in January of 1991. Messrs. Miklich and Ault verbally discussed the idea for a couple of hours. During that conversation, Mr. Miklich would occasionally refer to a pile of papers that were not shown to Mr. Ault. At that time, Mr. Ault was asked by Mr. Miklich to become a board member of the companies because he had an excellent financial background that would be valuable to the companies responsible for managing and investing significant funds. Mr. Ault accepted the positions on the boards because they would afford him the opportunity to expand his experience regarding the safekeeping of valuable assets, i.e., the Marks.

45. Mr. Ivy, Vice President of Corporate Planning and Development and then Treasurer of Sherwin-Williams, was invited to become a board member of the companies because he had often expressed concern over the way Sherwin-Williams had managed its Marks. Although the demands on his time were great, Mr. Ivy agreed to serve as a director of the companies responsible for managing and protecting the Marks.

46. Mr. Stewart was selected as a director of each board because of his expertise in Delaware law.

47. Since one of the reasons for forming SWIMC and DIMC was to maximize the rates of return on investments, Dr. Puglisi was selected as both an officer and director of the corporations. His significant financial and investment experience, his management skills and his

ability to be an effective decision maker motivated his selection as an officer and director of both companies.

48. Given SWIMC's and DIMC's focus upon the management of the Marks and investment of funds, the fact that Dr. Puglisi had no prior experience in trademark law or the paint business was not viewed as critical. Bringing in senior executives from different industries is not unusual. While neither Mr. Breen nor Mr. Ivy knew anything about the paint business when they joined Sherwin-Williams in 1979, they brought their managerial experience to the table.

49. The first meetings of the boards of directors of both SWIMC and DIMC took place on February 1, 1991. The directors of each company ratified the acts of the incorporator and elected officers. At that time, Mr. Ault was elected Chairman of SWIMC and DIMC. Dr. Puglisi was elected President and Treasurer of SWIMC and DIMC. Mr. Stewart became the Secretary of both SWIMC and DIMC and Mr. Michael Semes, an associate at Duane, Morris, was elected as SWIMC's and DIMC's Assistant Secretary.

50. None of SWIMC's and DIMC's officers was affiliated with Sherwin-Williams. Having SWIMC's and DIMC's officers unaffiliated with Sherwin-Williams was a volitional attempt to ensure that SWIMC and DIMC were separate from and not substitutes for the Divisional structure that had not fared well in managing and protecting the Marks.

51. Employment agreements were entered into by SWIMC and DIMC with each of the officers. Under the terms of each employment agreement, Dr. Puglisi, as President and Treasurer, was to receive $18,000.00 per year for his services; while Mr. Stewart and Mr. Semes were each to receive $500.00 per year for their services as Secretary and Assistant Secretary, respectively.

52. The minutes of the initial meeting of SWIMC's board of directors indicate that Sherwin-Williams transferred $50,000.00 and its ownership right, title and interest in certain Marks, "and all goodwill associated therewith, along with all registrations, pending registrations and a license thereof and a licensing agreement" in exchange for 1,000 shares of SWIMC stock, par value $0.01. No gain was recognized by Sherwin-Williams on this exchange pursuant to Internal Revenue Code ("IRC") § 351.

53. By an Assignment Agreement dated January 31, 1991, Sherwin-Williams assigned "all of its ownership right, title and interest in and to the SW Property (as defined in the [SWIMC] Capital Contribution Agreement), including all registrations and pending registrations therefor, which are more particularly identified on Exhibit A attached hereto." The Exhibit A attached to the agreement refers to the "tradenames, trademarks and service marks and all goodwill associated therewith . . . identified on the attached list." No list is attached to the agreement that is in the record. However, the record does include the Agreement Regarding Capital Contribution Between The Sherwin-Williams Company and SWIMC, Inc. ("SWIMC Capital Contribution Agreement") referenced in the Assignment Agreement. Approximately 420 Marks that constitute a part of the SW Property are identified on a list that is attached to Exhibit A of the SWIMC Capital Contribution Agreement.

54. The minutes of the initial meeting of DIMC's board of directors indicate that Sherwin-Williams transferred $42,500.00 and its ownership right, title and interest in certain Marks, "and all goodwill associated therewith, along with all registrations, pending registrations and a license thereof" in exchange for 850 shares of DIMC stock, par value $0.01. No gain was recognized by Sherwin-Williams on this exchange pursuant to IRC § 351. The minutes also indicate that Dupli-Color transferred $7,500.00 and its ownership right, title and interest in certain Marks,

"and all goodwill associated therewith, along with all registrations, pending registrations and a license thereof" in exchange for 150 shares of DIMC stock, par value $0.01.

55. By an Assignment Agreement dated January 31, 1991, Sherwin-Williams assigned 120 Marks to DIMC.

56. The assignments of the Marks to SWIMC and DIMC were recorded in the United States ("U.S.") Patent and Trademark Office. As a result of the assignments, SWIMC and DIMC became the owners of the Marks.

57. At both SWIMC's and DIMC's initial meetings, the directors authorized and directed Dr. Puglisi and Mr. Stewart to, among other things, engage a financial institution to perform custodial services; open a checking account at the Bank of Delaware; enter into agreements for the provision of services related to the management and protection of the Marks; and to enter into license agreements with Sherwin-Williams for its licensing of certain Marks on a nonexclusive basis upon the payment by Sherwin-Williams of royalty fees that represented a "fair value" for the use of those Marks.

58. At those initial meetings, Dr. Puglisi and Mr. Stewart were each given the authority to write checks up to the amount of $2,000.00 on the corporate checking accounts. Amounts in excess of that amount required the approval of either Mr. Ault or Mr. Ivy, the two non-officer directors.

The License Agreements

59. On February 1, 1991, license agreements were entered into pursuant to which SWIMC and DIMC would license certain of their respective Marks to Sherwin-Williams ("License Agreements"). Pertinent provisions of the License Agreements are set forth below.

60. Section 1(c) of each of the License Agreements grants Sherwin-Williams ("licensee") the nonexclusive right to use certain Marks and all goodwill associated therewith

> in connection with the manufacture, distribution and sale of products and services in the United States as approved by Licensor (herewith such approved products and services are collectively referred to as 'Approved Products'). It is expressly understood that Approved Products shall include all products and services which were provided, manufactured, distributed or sold by Licensee in conjunction with one or more of the Trademark(s) prior to the date of this Agreement and shall also include such other products and services which fall within the description of goods of the corresponding registrations or common law usages of the Trademark(s), provided such products and services comply with the standards determined by Licensor as set forth herein and/or issued pursuant to this Agreement. The standards to be determined by Licensor shall include, without limitation, the quality of the goods or services, the labeling and advertising uses of the Trademark(s), and the performance requirements of new products or services intended to be provided under the Trademark(s). Licensor acknowledges that such policies as currently followed by Licensee are satisfactory to Licensor, but Licensor reserves the right to withdraw its approval or amend its standards at any time.

61. Section 2 of each of the License Agreements sets forth quality control standards that must be maintained with respect to the "Approved Products provided in conjunction with the Trademark(s), in order to enhance goodwill as symbolized by the Trademark(s)." SWIMC and DIMC are given, among other things, the right to (a) "approve all advertising in connection with the Approved Products," (b) issue quality control standards, "together with accompanying quality control policies and procedures" and (c) demand "descriptions of all activities currently performed and/or being completed by Licensee relating to the Approved Products and of the manner of performing same," in order to "determine whether the high standards and quality control measures are being maintained by Licensee." The License Agreements stipulate that "Licensor (or its authorized representative) shall be the sole judge of whether the activities of Licensee have complied or are complying with the aforesaid high standards and quality control measures."

62. Section 2(h) of each of the License Agreements provides:

> In the event that Licensee at any time makes any changes in its business procedures that may alter the performance of any of the services or the delivery of products upon or in relation t [sic] which Licensee uses or intends to use the Trademark(s), Licensee shall promptly give notice in writing thereof to Licensor or its authorized representative, so that Licensor or its authorized representative may determine through supplemental investigation, if necessary, in the Licensor's sole judgment, whether Licensee is conforming to the high standards and quality control measure [sic] which have been set forth herein, and Licensee shall abide by the decision of Licensor or its authorized representative in this respect.

63. Under the terms of each license agreement, Sherwin-Williams agrees "to pay Licensor for the license of the Trademark(s) for each calendar quarter a royalty ('Royalty Fees') in the percentage amount set forth on Exhibit C, of Licensee's Royalty Base." Exhibit C sets forth the following royalty rates based upon sales by individual divisions: Stores 2.5%; Consumer 2.5%; Automotive 4.5%; Chemical Coatings 1.0% and Specialty Products 4.0%.

Section 3(b) of each License Agreement defines the royalty base as "the invoiced sales value of all Approved Products sold" by the licensee less such items as returned, lost or damaged Approved Products, and is therefore the same as what is generally considered to be net sales.

Section 3(c) of the License Agreements requires Sherwin-Williams to pay the royalty fees due for each quarter within 60 days of the end of each calendar quarter. Along with the payment, Sherwin-Williams must submit an itemized statement "setting forth sales and production reports in sufficient detail for verification, and showing the basis upon which said Royalty Fee is determined and payable."

64. The License Agreements are for a ten-year period, although they can be terminated by either party at any time by reason of the breach or default of the other party. At the end of the 10-year period, SWIMC and DIMC have the right to terminate the agreements with six months

written notice of termination, at which point Sherwin-Williams would be required to "immediately cease to use the Trademark(s) for any and all purposes."

65. SWIMC and DIMC licensed to Sherwin-Williams only those Marks that were going to be used by Sherwin-Williams. For example, the "Dutch Boy" Marks that were licensed to Taracorp, Inc. ("Taracorp"), a third party, were not licensed to Sherwin-Williams.

Establishment of Royalty Rates

66. In November 1990, Sherwin-Williams engaged the services of American Appraisal Associates ("AAA"), the world's largest independent appraisal firm, to determine the fair market value of the domestic trademarks and trade names of Sherwin-Williams. Prior to the November 1990 engagement, AAA had provided Sherwin-Williams with valuations for various pieces of real estate. Sherwin-Williams never told AAA that it wanted any particular royalty rates and AAA's fees were not dependent upon the results of its appraisal.

67. On December 7, 1990, Mr. McDonald sent Diane Benkler of AAA "the April 2, 1990 list of abstracts of [Sherwin-Williams'] foreign license agreements." That list is not part of the record.

68. On or about January 15, 1991, the conclusions reached by AAA in its valuation study were provided to Sherwin-Williams.

69. By letter dated February 4, 1991, a draft of AAA's appraisal report was remitted to Sherwin-Williams. The letter invited comments from Sherwin-Williams. The record does not include a copy of the draft appraisal report. It is AAA's policy to supply a draft appraisal report after the conclusions are given to the client.

70. Based upon AAA's valuation study, valuations were placed on the Marks and royalty rates were determined with respect to the Marks. The appraisal report, furnished on April 10,

1991, determined that, as of January 31, 1991, the fair market value of Sherwin-Williams' domestic trademarks was $328,000,000.00 and the appropriate royalty rates based on sales by individual divisions were: Stores 2.5%; Consumer 2.5%; Chemical Coatings 1.0%; Automotive 4.5% and Specialty Products 4.0%.

71. In determining the fair market value of the Marks, AAA first determined the appropriate royalty rates for the Marks. A search was made for comparable royalties being charged for the use of similar marks. Next, the royalty rates derived from an analysis of the comparables were refined by subjecting them to a reasonability test. The royalty rates used in determining the fair market value of the Marks were within the ranges determined by the reasonability test and the comparability study.

72. Mr. Richard Billovits, a vice president and principal at AAA, testified on behalf of petitioner regarding the AAA report. Although he did not participate in the preparation of the report, Mr. Billovits did review the work papers used in the preparation of that report. However, he did not recall seeing the draft appraisal report in the file containing the work papers. Mr. Billovits was accepted as an expert in the appraisal of intangible assets.

73. The AAA study was performed using a form of the income approach known as the "relief from royalty approach." In that approach, a determination is first made of the arm's length royalty rates that a holder of trademarks would charge to a person who wanted to license the trademarks. The royalty rates determined are then applied to the projected sales to determine the expected royalties that would be required to be paid if the owner of the trademarks did not own them and was required to license them. These amounts are then discounted to derive their present value.

74. AAA began its determination of the royalty rates for the domestic trademarks by trying to find comparable license transactions in either paint or similar fields, but was unable to find any comparable third-party transactions. However, Sherwin-Williams did supply AAA with the abstracts of 57 foreign third-party licenses for the use of Sherwin-Williams' Marks. The actual license agreements were never furnished to AAA. The report does not provide any details about the licenses, including the names of the licensees or the terms of the agreements.

75. AAA reviewed and analyzed the foreign license abstracts. After elimination of a 0.5% rate for a license for the use of the "Dutch Boy" name on lead pipes, which had expired in 1987 and was not considered comparable to a license of a Mark for use on paint products, the rates were determined on a divisional basis and ranged from 1% to 7% . In refining the rates on a divisional basis, AAA analyzed the operating profits of each of Sherwin-Williams' divisions and applied the rule of thumb used in evaluating trademark licenses (i.e., that a licensee will typically pay between 25% to 33⅓% of its operating profit for its right to use a trademark). AAA determined the following ranges of royalty rates: for Stores Products a range of 1.9% to 2.6%; for Consumer Products a range of 2.1% to 2.8%; for Chemical Coatings Products a range of 0.2% to 1.5%; for Automotive Products 3.7% to 4.9%; and for Specialty Brands a range of 3.5% to 4.6%. Instead of using the entire range of 25% to 33⅓%, AAA chose 30% as the appropriate range and applied 30% to the average operating profit of each of the divisions. The royalty rates determined for each division were: Stores Products 2.5%; Consumer Products 2.5%; Chemical Coatings 1%; Automotive Products 4.5%; and Specialty Brands 4%.

76. Mr. Billovits corroborated the arm's length royalty rates determined in the appraisal by further evaluation of the abstracts of the 57 foreign licenses. He reviewed the Sherwin-Williams 1991 Annual Report and determined that none of the foreign licensees were listed as subsidiaries.

Mr. Billovits also checked with Sherwin-Williams to determine if it had an ownership interest in any of the licensees. He was informed by Sherwin-Williams' personnel that Sherwin-Williams did not control 50% of the stock of any of the foreign companies that were parties to the licenses, although Sherwin-Williams had up to a 20% interest in a few of the licensees.

77. Mr. Billovits admitted that a company may have control over another business through means other than stock ownership. He admitted that provision of technology is one way to exert a controlling interest over another company. He also admitted that the value of a trademark depends in part on the size of the market within which it is employed.

78. Mr. Billovits received assurances from Sherwin-Williams' personnel that 25 of the foreign license agreements had no provisions for the transfer of technology in conjunction with the trademarks or had a provision for the transfer of only low-level technology. He determined the royalty rates of the 25 foreign license agreements to be within the range of 1% to 5%. Based on his determination that the foreign royalty rates ranged from 1% to 5%, he concluded that the royalty rates determined by AAA for the various divisions represented arm's length royalty rates.

79. AAA then valued the trademarks using the relief from royalty method. The royalty rates determined for each division were applied to 10-year projections of revenue on a divisional basis, and the after-tax royalty savings related to the divisional sales were discounted to present value at a 20% adjusted cost of equity. Since trademarks have an unlimited life, AAA determined the value beyond year ten by taking the division's final year's royalty savings as a result of owning a trademark and capitalized it at the discount rate less the stabilized growth rate that varied by division, but was either 4% or 5%. Based on its computations, AAA determined the fair market value of Sherwin-Williams' domestic trademarks to be $328,000,000.00.

80. The appraisal report includes an explanation of how the adjusted cost of equity was determined. "The discount rate was developed in a process that incorporated aspects of economic theory, capital budgeting techniques and the Arbitrage Pricing Theory ("APT")."[5] The formula used to calculate the equity discount rate was Re = Rf + [B x (Rm – Rf)], where Re equals the required return (cost of equity); Rf equals the risk-free rate of return; B equals Beta, a statistical measure of the sensitivity and relationship between the subject (company and comparative companies) risk and the market viewed as one; and Rm – Rf equals the expected return of the market in excess of the risk-free rate.

The risk-free rate of return was based on long-term treasury bonds that, at the appraisal date, were priced to yield 8.08%. AAA estimated the expected return of the market in excess of the risk-free rate to be 7.29%, based on historical studies of actual returns required of equity investments over long-term bond investments. The APT Beta factor for comparable companies in the coatings industry was determined to be 1.366. The report does not identify the companies used or the betas for those companies. Utilizing these three components, an average cost of equity return was determined as follows: 8.08 + (1.366 x 7.29) = 18.04%. AAA added a 2% additional risk premium on the theory that trademarks are "elements of going concern and more subject to public volatility" and determined the adjusted cost of equity to be 20%.

81. Mr. Billovits explained that the method actually used by AAA to determine the discount rate was a combined methodology of APT and the Capital Asset Pricing Method ("CAPM"). He did not explain the equation for this hybrid formula. According to Mr. Billovits, the beta used in the report was based on an average beta for four companies and that the beta data

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[5] The APT is a multi-factor asset pricing model developed by Stephen Ross in 1976. It is a method used to estimate the risk premium associated with an asset.

for the comparables was furnished by an unidentified consulting firm. The documents from that consulting firm are not in the record. With respect to the 2% risk premium factor, Mr. Billovits stated that it is commonly used to show the risk of trademarks. According to Mr. Billovits, trademarks are one of the more risky assets that a business can own. This is because trademarks will drop in value more than other assets of a company when it experiences significant operational problems.

82. Mr. Billovits, as an expert in valuing intangible property, opined that the royalty rates charged by SWIMC and DIMC to Sherwin-Williams constituted arm's length rates.

Services Agreement

83. On February 1, 1991, SWIMC and DIMC each contracted with Sherwin-Williams to provide certain trademark services for them. Under the terms of each Services Agreement, Sherwin-Williams, as trademark service provider, is to provide various trademark support services, including identifying renewal and affidavit dates for the trademarks, providing registration services, licensing assistance and advice relating to trademark protection and enforcement.

84. Each Services Agreement has a Fee Schedule that sets forth the charges for the services to be performed by Sherwin-Williams as trademark service provider. The following charges for the services were set in accordance with the American Intellectual Property Law Association ("AIPLA")[6] guidelines:

Filing trademark application	$ 290.00
Prosecution of trademark application	$ 415.00
Trademark appeal to Board	$2,050.00
Trademark section declarations	$ 220.00
Trademark renewal applications	$ 235.00
All other work shall be billed at $140.00 per hour.	

[6] AIPLA is an independent trade organization that conducts a survey of legal fees for various legal services in different geographical areas.

85. At SWIMC's and DIMC's request, Sherwin-Williams did, among other things, provide the trademark docketing services and the maintenance reminder system to ensure timely renewals of the Marks, helped with the licensing enforcement and provided legal interpretation.

86. Sherwin-Williams provides SWIMC and DIMC with quarterly invoices that are paid by check.

87. At its April 30, 1991 meeting, SWIMC's directors authorized its President and Secretary "upon consent of the licensee" Sherwin-Williams, to amend the royalty payment and sales reporting provisions (Section 3[c]) of the License Agreement, as follows: (1) the licensee was to provide a sales production report by Division within 60 days of the end of each calendar quarter, and (2) payment of the royalty would be due within 30 days of an invoice sent by SWIMC.

88. Although the Division subpoenaed "all inter-company agreements," Sherwin-Williams did not produce any amendment to the SWIMC license agreement embodying this change in the due date of Sherwin-Williams' royalty payments.

89. The change in the due date for petitioner's royalty payments was needed because Sherwin-Williams could not capture the information and get it to Dr. Puglisi in a timely manner to allow him to determine the correct amounts of royalties to be billed to Sherwin-Williams. Although Dr. Puglisi committed himself to trying to find the amendment to the SWIMC License Agreement that changed the payment paragraph, no such amendment was produced by Sherwin-Williams at the hearing.

90. The minutes of DIMC's April 30, 1991 directors' meeting also indicate that Dr. Puglisi and Mr. Stewart were authorized to amend Section 3(c) of the respective License Agreements with Sherwin-Williams and Dupli-Color. The amendment to DIMC's License Agreement reflecting the changes to Section 3(c) is not in the record.

91. The record includes copies of the royalty billing records for the period in issue. Review of those records indicates that typically Sherwin-Williams sent SWIMC and DIMC the sales production reports within 30 to 45 days of the end of the quarter and SWIMC and DIMC sent invoices to Sherwin-Williams about 60 days after the end of the quarter, demanding payment within 30 days of the date of the invoices. Starting in August 1991, Sherwin-Williams began sending Dr. Puglisi, as President of SWIMC and DIMC, quarterly estimates of sales covered by its licensing agreements with SWIMC and DIMC.

92. The July 29, 1991 SWIMC Board of Directors minutes contain a discussion about the dissolution of Sherwin-Williams' Chemical Coatings Division. The minutes indicate that the net sales out of the Chemical Coatings Division had been "approximately $60 million of which approximately 75% would now be sold under the Stores Division, with the remaining 25% sold under the Automotive Division." The minutes also indicate that the directors discussed the appropriate method of determining the proper royalty rate for the sales formerly reported by the Chemical Coatings Division. The Board decided to leave the royalty rate unchanged, unless objective evidence of a lower royalty rate was presented by the licensee. SWIMC's Board directed that the License Agreement, upon the consent of the licensee, be amended to reflect the transfer of sales from the Chemical Coatings Division to the Stores Division and the Automotive Division. That amendment is not part of the record.

93. A review of the sales production reports sent to SWIMC by Sherwin-Williams indicate that, as of August 1991, sales were no longer reported for the Chemical Coatings Division.

94. A review of SWIMC's October 21, 1991 Board of Directors minutes indicate that Dr. Puglisi had received a letter of appraisal for the Chemical Coatings trademarks. According to the minutes, the sales from the Chemical Coatings Division were being included in sales from the

Automotive and Consumer divisions and "the appraisal confirmed that no change in the royalty rate under the license agreement for those Divisions" was necessary.

95. During 1991, Sherwin-Williams contributed additional trademarks to SWIMC and DIMC.

On May 1, 1991, six additional trademarks were assigned to SWIMC. The License Agreement was amended to grant Sherwin-Williams the right to use those additional trademarks.

In 1991, Sherwin-Williams continued to acquire additional product lines including the assets of the "Cuprinol" product line of wood stains and preservatives from Ensign-Bickford Industries, Inc. and certain assets of Cook Paint and Varnish Company. On August 1, 1991, Sherwin-Williams assigned to SWIMC as an additional contribution of capital, the eight Marks related to the "Cuprinol" product line. The book value of those Marks was $515,000.00. The License Agreement was amended to grant Sherwin-Williams the right to use those additional trademarks effective as of August 1, 1991. The sales related to the "Cuprinol" trademarks were included in the sales production reports that Sherwin-Williams sent to SWIMC commencing on August 1, 1991.

On October 15, 1991, Sherwin-Williams assigned the "E-Prime" and "Interlock" trademarks to SWIMC. The License Agreement was amended to allow Sherwin-Williams to use those additional trademarks effective as of October 15, 1991.

On October 15, 1991, Sherwin-Williams transferred the "Rust Tough" trademark to DIMC. The License Agreement was amended to grant Sherwin-Williams the right to use that additional trademark effective as of October 15, 1991.

Operation of SWIMC and DIMC

96. On February 1, 1991, Dr. Puglisi executed a lease agreement for office space in Wilmington, Delaware. That office was solely SWIMC's and DIMC's; no other party shared the

office with them. The two corporations shared an office (approximately 9 ft. by 9 ft. in dimension), Suite 522 in the Bank of Delaware Building, located at 300 Delaware Ave., Wilmington, Delaware. In 1991, the monthly rent was $750.00, the payment of which was split equally by SWIMC and DIMC. The Wilmington, Delaware office contained standard office equipment, including a desk and desk chair, two additional chairs, a filing cabinet and a telephone with two separate phone lines, one for SWIMC and the other for DIMC. In 1991, the telephone bills for the companies were nominal. All correspondence issued on behalf of either SWIMC or DIMC contained the Wilmington address. Additional services provided by the Wilmington landlord included the provision of a receptionist who answered and forwarded all SWIMC and DIMC calls as well as their mail to Dr. Puglisi at Puglisi and Associates, Inc.'s Newark, Delaware office. The companies continue to lease the office in Wilmington, Delaware.

97. In January 1992, for the convenience of Dr. Puglisi, additional office space was subleased at 1500 Casho Mill Road, Suite 3D, Newark, Delaware from Puglisi and Associates, Inc. At that location, SWIMC and DIMC shared one office, approximately 10 ft. by 10 ft. in dimension, which contained a desk, a chair, a computer sitting on a small side table, a telephone and a wooden double-width file cabinet. No other party shared that office. The rent was $360.00 per year per company for the Newark office. Puglisi and Associates, Inc. has since moved to 850 Library Avenue, Newark, Delaware. SWIMC and DIMC continue to sublease an office, approximately 10 ft. by 10 ft. in dimension, from Puglisi and Associates, Inc.[7] The Newark office rent continues to be $360.00 per year per company.

[7] The record is silent as to when Puglisi and Associates, Inc.'s lease expired at the Casho Mill Road location and the company moved to its current suite of offices at Library Avenue.

98. During the period in issue, Dr. Puglisi conducted SWIMC's and DIMC's day-to-day operations from his office in Newark where he kept all current records for both corporations.

99. All of the Marks are registered to the address in Wilmington. The primary reason that office is maintained is that if a permanent address were not maintained, then every time SWIMC and DIMC were to move to a different location the official recordation of every SWIMC and DIMC Mark would need to be changed, a costly proposition. The Wilmington, Delaware office is used for the storage of historical records.

100. SWIMC and DIMC each opened checking and custodial accounts with The Bank of Delaware. The Marks were physically transferred into the Delaware custodial accounts. Each corporation paid the custodial fees assessed by the Bank of Delaware for the safekeeping of its respective Marks. All royalty payments received by SWIMC and DIMC were deposited into their respective custodial accounts.

101. Deposit accounts at the U.S. Patent and Trademark Office were set up in the names of both SWIMC and DIMC for purposes of, among other things, registration and assignment of Marks. Each corporation's deposit account was funded and replenished via checks drawn on its respective checking account.

102. In 1991, as part of his responsibilities Dr. Puglisi maintained, among other things, each company's books; paid the bills; responded to all correspondence and telephone calls and prepared the monthly and quarterly financial statements that were presented to SWIMC's and DIMC's directors at the quarterly board meetings.

103. Subsequent to 1991, audits in accordance with generally accepted auditing standards and generally accepted accounting principles and quality control services were rendered to

SWIMC and DIMC by Wade and Santora, a certified public accounting firm located in Delaware. Wade and Santora was not related to and did no work for Sherwin-Williams.

104. As a result of those audits, Wade and Santora issued audited financial statements for SWIMC and DIMC. Certified financial statements could be issued because Dr. Puglisi provided independent management to SWIMC and DIMC. Certified financial statements were necessary in the event that securitized financing was ever needed.

105. In addition to his responsibilities as Secretary of SWIMC and DIMC, Mr. Stewart provides legal services to those corporations. During 1991, legal services were provided by Mr. Stewart to both SWIMC and DIMC. Each corporation paid Duane, Morris for those services.

106. In 1991, Mr. Spiro Bereveskos, a trademark attorney in Indiana, also provided legal services to SWIMC.

107. Payroll tax returns and administrative filings were handled by SWIMC and DIMC.

108. SWIMC and DIMC paid their respective shares of the federal consolidated tax liabilities, pursuant to Tax Sharing Agreements they entered into with Sherwin-Williams. SWIMC and DIMC paid $8,505,749.00 and $1,351,941.00, respectively, in federal income taxes for 1991. According to the audited financial statement issued by Wade & Santora, SWIMC's and DIMC's current provisions for federal income taxes for 1991 were: $13,722,400.00 and $2,254,527.00, respectively.

109. By letters dated March 26, 1991, the Delaware Division of Revenue issued rulings that SWIMC and DIMC were exempt from Delaware income taxes in accordance with 30 Del. C. § 1902(b)(8).

110. Providers of services to SWIMC or DIMC received payment from SWIMC or DIMC for such services.

Corporate Form

111. In 1991, SWIMC and DIMC held separate quarterly meetings of their boards of directors in Delaware at the offices of Duane, Morris. The meetings occurred on the same day, one right after the other. Each corporation's initial board of directors meeting lasted 30 minutes. The April 30, 1991 and October 21, 1991 meetings lasted one hour for each corporation. The meetings held on October 21, 1991 each lasted 40 minutes. Minutes were taken of all meetings. As Secretary of SWIMC and DIMC, Mr. Stewart maintained the corporate minute books for each company. Dr. Puglisi retained the corporate minute books for each company at the Wilmington office. Mr. Stewart retained a duplicate set of minutes for each company.

112. Although Delaware law permits telephone participation at board meetings, SWIMC's and DIMC's directors were always physically present.

113. Prior to each meeting an agenda was provided to the directors, as were certain reports that would be discussed at the meeting, including lists of investments and financial statements and minutes from the prior meeting. The reports discussed the status of various Mark-related matters, including oppositions and infringements, and would provide a 12-month forward-look of Marks for which some action, such as renewals, might be needed.

114. During such meetings held in subsequent years, SWIMC's and DIMC's boards of directors elected the corporations' officers and discussed the respective company's business. Those meetings would generally last about an hour-and-a-half to two hours for each corporation. At those subsequent meetings, the external auditors would often be present. Minutes were taken for all meetings. All meetings were held in Delaware.

115. In addition to the quarterly Board meetings, an annual shareholder meeting took place in Delaware for each corporation. Minutes were taken for all such meetings.

Trademark Maintenance and Protection

116. In its role as trademark service provider, Sherwin-Williams maintained the dockets of Marks owned by SWIMC and DIMC and notified them when action needed to be taken, such as when an affidavit of use needed to be filed.

117. During 1991, SWIMC and DIMC paid for and filed trademark applications and renewals. Registration fees and other charges were paid from deposit accounts that SWIMC and DIMC each maintained with the U.S. Patent and Trademark Office. That practice continues to this day.

118. Since the formation of SWIMC and DIMC, Dr. Puglisi has determined whether or not a Mark should be renewed and, since that time, no Marks have unintentionally expired.

119. When a potential infringer is identified, Dr. Puglisi determines whether or not to take measures against the potential infringer. Typically, infringers are paint companies or painters that state on their advertisements that they use paint carrying SWIMC's or DIMC's Marks. Often these infringers are unaware that they have done anything improper, and a letter from, or authorized by, Dr. Puglisi is all that is needed to rectify the problem.

120. Since the formation of SWIMC and DIMC in 1991, Dr. Puglisi has independently monitored retailers and other sources for potential infringers.

121. During 1991, on behalf of SWIMC and DIMC (depending on the Mark involved), the trademark service provider sent correspondence concerning proposed third-party license agreements, trademark infringement, trademark misuse, disparaging advertising and opposition to third-party application for registration of a Mark.

122. Sherwin-Williams provided SWIMC and DIMC with quarterly invoices that were paid by check. Those quarterly invoices outlined the trademark services provided and the

amount of time spent on each matter. In 1991, for services rendered by Sherwin-Williams as trademark service provider, SWIMC paid $12,568.00 and DIMC paid $1,755.00.

123. At the April 30, 1991 meetings of SWIMC's and DIMC's directors, the need for quality control procedures was discussed. At that time, the directors of both companies authorized Dr. Puglisi to obtain the assistance of (1) the trademark service provider for purposes of developing quality control guidelines and (2) the services of Karen Starr, a certified public accountant affiliated with Wade & Santora, as a quality control service provider with responsibilities for monitoring quality control guidelines through use, among other things, "of a quality control compliance certification to be obtained periodically from licensees of the trademarks and other similar property." Review of the minutes of the July 29, 1991 and October 21, 1991 meetings of SWIMC's and DIMC's directors indicate that the trademark service provider was continuing the process of finalizing the Quality Control Service Provider Agreement ("Quality Control Agreement") that was to be entered into with Wade & Santora.

124. In 1991, neither SWIMC nor DIMC performed any quality control product testing.

125. On August 19, 1992, SWIMC and DIMC each entered into a Quality Control Agreement with Wade & Santora. Ms. Starr executed the agreements on behalf of Wade & Santora. As quality control service provider, Wade & Santora was to monitor the "licensees' performance of their respective obligations with respect to the Quality Control Standards under each of the license agreements" and report the results back to either SWIMC or DIMC depending upon the license involved.

126. Subsequent to 1991, Dr. Puglisi initiated physical testing of products. A number of products bearing SWIMC's and DIMC's Marks were sent to an independent laboratory for physical testing. The quality control performed on the Marks by SWIMC and DIMC is distinct

from the quality control that manufacturers routinely perform on their products to ensure that they meet performance standards. Prior to the formation of SWIMC and DIMC, this type of testing was not done.

127. As noted above, Sherwin-Williams had one third-party domestic license agreement that it transferred to SWIMC. That license agreement was with Taracorp for the exclusive use of certain “Dutch Boy” Marks on various solder products identified in the license agreement. The license agreement required Taracorp to make quarterly payments based upon the amount of solder sold. If the amount of solder sold was less than a certain amount, then a minimum quarterly payment was due.

128. After the assignment of the license to SWIMC, Taracorp made quarterly royalty payments to SWIMC. During 1991, SWIMC’s trademark service provider reviewed Taracorp’s compliance with the terms of the licensing agreement.

129. In 1991, SWIMC and DIMC did not have any third-party licensing marketing programs. Rather, SWIMC and DIMC learned of potential third-party licensing opportunities from Sherwin-Williams when it would forward the licensing inquiries that were received by its operating divisions.

130. During 1991, SWIMC entered into license agreements with third parties. Those licenses are similar to the License Agreements with Sherwin-Williams. The royalty rates determined by AAA were used as a guide in determining third-party royalties.

131. On November 26, 1991, SWIMC granted Startex Chemical, Inc. (“Startex”) a non-exclusive, non-transferrable license to use the “So Fast” trademark on solvents, thinners and related products in the continental United States. The license agreement required Startex to “exercise its best efforts to use and exploit the right and license granted herein” and agree “to

promote and expand the market" in the United States for the licensed products. Under the license agreement, Startex agreed to pay SWIMC the sum of 25 cents for each gallon of the licensed product manufactured and sold by it. The royalties were payable quarterly within 30 days of the end of each calendar quarter, along with an "accurate itemized certified statement setting forth sales and production reports in sufficient detail" to allow for verification of the royalties determined to be due. There was also a provision for the imposition of interest if a late payment was made.

132. In the summer of 1991, SWIMC received a request from Plastic Specialties and Technologies, Inc. ("Plastic Specialties") for an exclusive license for the use of the "Dutch Boy" trademark on garden hoses. Prior to entering into the license agreement, Dr. Puglisi, as president of SWIMC, requested and received a sample of the garden hose to review.

133. The license agreement between SWIMC and Plastic Specialties was effective as of January 1, 1992 and granted Plastic Specialties an exclusive license to use certain trademarks including Marks and logos representing a Dutch Boy and/or using the words "Dutch Boy" on plastic garden hose in the United States, including its territories and possessions. The license agreement required Plastic Specialties to submit to SWIMC samples from its first production batches of each type of garden hose to be sold under the licensed trademarks. It also required Plastic Specialties to submit to SWIMC for prior approval all labels, advertising and promotional materials related to the sale and marketing of the garden hoses. Under the license agreement, Plastic Specialties agreed to pay a royalty of 5% of the net sales price of all the licensed product sold or otherwise disposed of by it. The royalties were payable quarterly within 30 days of the end of each calendar quarter, along with "an accurate itemized certified statement setting forth in

sufficient detail for verification, the basis upon which such payment is determined and made." There also was a provision for the imposition of interest if a late payment was made.

134. During 1991, SWIMC also entered into a third-party license agreement with Minntertainment Company ("Minntertainment"). The license agreement granted Minntertainment the right to use certain trademarks, including the "Cover the Earth" Mark, identified in the license agreement, "solely for the purpose of fulfilling its obligations to Sherwin-Williams" under the terms of the Mall of America Official Sponsor Agreement, "including, without limitation, promoting Sherwin-Williams as the exclusive paint supplier for the Mall of America." Minntertainment was not required to pay a royalty for its use of the trademarks. Under the license agreement, SWIMC reserved the right to approve all advertising and promotion in connection with the use of the trademarks. Minntertainment was also required to submit a representative sample of its initial proposed use of any of the trademarks for SWIMC's approval.

135. In 1991, DIMC did not enter into any third-party licensing agreements. However, in November 1992, DIMC entered into a licensing agreement with Blue Coral, Inc. ("Blue Coral"). The license agreement granted Blue Coral an exclusive license to use certain "Dupli Color" trademarks in connection with the manufacturing, distribution, advertising and sale of "liquid car wax products containing pigments and colorants designed to match or approximate the existing finish of automobiles" ("authorized products").

136. Under the terms of the licensing agreement, DIMC required Blue Coral to submit samples of all authorized products and samples of the raw materials used in the authorized products. The license agreement also required Blue Coral to submit to DIMC for its prior approval, "all labels, advertising and promotional materials or changes thereto," relating to the

sale and marketing of the authorized products. Blue Coral was also required to use its "reasonable best efforts to use and exploit the right and license granted herein" and agreed "to promote and expand the market" in the United States, including its territories and possessions ("the territory"). That license agreement also stated that at DIMC's discretion, the territory "may be expanded to other countries for the sale of the authorized products on a non-exclusive basis."

137. Since the formation of SWIMC and DIMC, Sherwin-Williams has brought some potential third-party license proposals to the attention of SWIMC and DIMC but, on more than one occasion, Dr. Puglisi rejected the proposals. Proposals rejected by Dr. Puglisi included a license for hair spray paint, the use of Marks in violent or pornographic movies, and the use of the "Krylon" Mark on tee-shirts.

138. Although their original certificates of incorporation required prior shareholder approval of any license agreements, in practice and as intended by the boards of directors, SWIMC and DIMC entered into whatever license they determined to be prudent and the shareholder would ratify their actions at the annual meetings. The certificates of incorporation have been amended and no longer provide for prior shareholder approval.

139. Shortly before SWIMC was formed, Sherwin-Williams commenced an opposition proceeding against National Waterproofing. An opposition proceeding is an administrative proceeding brought to challenge a pending application for use of a trademark. An opposition proceeding was brought to prevent National Waterproofing from registering a trademark that displayed a person, which strongly resembled SWIMC's "Dutch Boy," with his finger in a dike. After the transfer of the "Dutch Boy" mark to SWIMC, it was substituted as the party in that opposition proceeding.

140. On SWIMC's behalf, the trademark service provider, specifically Mr. McDonald, contacted Mr. Bereveskos, an Indiana trademark attorney. Mr. Bereveskos became lead counsel and Mr. McDonald acted as co-counsel in the opposition proceeding.

141. Once SWIMC was substituted, Dr. Puglisi made all significant decisions regarding the opposition proceeding. After an initial settlement offer proposed by SWIMC was rejected, depositions and discovery were conducted. After depositions and discovery, National Waterproofing agreed to abandon its use of SWIMC's Mark and withdraw its application. Dr. Puglisi, as president of SWIMC, executed the settlement documentation. He also paid the legal and consultant fees associated with the opposition proceeding.

Investment Activities

142. SWIMC and DIMC were not merely trademark protection companies. They were also investment companies.

143. Although the SWIMC and DIMC boards of directors established investment guidelines, day-to-day investment decisions were made by Dr. Puglisi.

144. The initial investment guidelines adopted by the directors at SWIMC's and DIMC's initial meetings were modeled after those of Sherwin-Williams. Under those guidelines, SWIMC's and DIMC's excess cash was invested in "Temp Fund" money market accounts to which funds were swept from their respective custodial accounts.

145. Dr. Puglisi presented modifications to the investment guidelines to the directors of SWIMC and DIMC at their respective July 29, 1991 meetings. At those meetings, the directors of each company adopted the modified investment guidelines. The directors of each company directed Dr. Puglisi "to invest on a daily 'sweep' basis cash balances in excess of $2,000 in a Bank of Delaware money market fund selected by" Dr. Puglisi, that had a competitive rate of

return. The directors of each company also authorized and directed Dr. Puglisi "to invest significant cash balances as determined by [him], in accordance with the Investment Policy" adopted by the board.

146. As amended pursuant to Dr. Puglisi's recommendations, SWIMC's and DIMC's investment guidelines allow for investment in longer-term and riskier investments than those allowed under Sherwin-Williams' guidelines. All investments, i.e., the purchase of commercial paper or securities, made by SWIMC and DIMC were held in their respective custodial accounts. A review of SWIMC's and DIMC's custodial accounts for 1991 indicates that investments purchased were short-term corporate securities that were held for approximately 7 to 30 days, i.e., until maturity.

147. At its April 30, 1991 meeting, SWIMC's directors considered a loan request from Sherwin-Williams for a 90-day loan proposed to bear interest at the 90-day London Interbank Offer Rate ("LIBOR") rates.[8] SWIMC's directors tabled discussion until the July 29, 1991 board meeting. At that meeting, they again considered the loan request. At that time, the directors adopted a resolution that authorized Dr. Puglisi to extend a loan to Sherwin-Williams,

> upon receipt of appropriate requests from such payor and all necessary and appropriate loan documentation, in a principal amount not to exceed $7 million, bearing the annual rate of interest of 90-day LIBOR rate plus three-eighths percent (⅜%), for a term of 90 days, with all interest and principal due upon maturity; provided, however, that such loan shall be made subject to adequate cash flow as determined by [him].

148. In October 1991, SWIMC loaned Sherwin-Williams $7 million. The rate SWIMC charged on that loan was 5.812% and was based upon the LIBOR plus three-eighths of 1 percent. The loan made by SWIMC to Sherwin-Williams was for a 90-day term, commencing on October

[8] The LIBOR is the benchmark for virtually all short-term basis lending in the world.

22, 1991, was memorialized in a written loan agreement, and was repaid early on January 17, 1992, with interest in the amount of $98,328.13.

Success of SWIMC and DIMC

149. The formation of SWIMC and DIMC has led to better management of the Marks.

150. Since the Marks were transferred to SWIMC and DIMC, no Marks have unintentionally expired, third-party licensing of the Marks has increased substantially and SWIMC and DIMC have earned a return on their investments in excess of that earned by Sherwin-Williams.

151. For the purposes of this proceeding only, Sherwin-Williams does not contest the Division's contention that it owned or controlled, either directly or indirectly, 80 percent or more of the voting stock of SWIMC and DIMC during the year 1991.

For the purposes of this proceeding only, Sherwin-Williams does not contest the Division's contention that, under New York law, it was conducting a unitary business with SWIMC and DIMC during the year 1991.

152. Petitioner filed a Federal consolidated income tax return for 1991 that included SWIMC and DIMC along with a number of other subsidiaries. On that federal consolidated return, petitioner reported the following amounts of income and expenses for SWIMC and DIMC.

	SWIMC	DIMC
Interest	$ 184,366.00	$ 32,600.00
Gross Royalties	$41,391,587.00	$6,795,759.00
Total Income	$41,575,953.00	$6,828,359.00
Deductions		
Salaries	17,417.00	17,417.00
Rents	4,125.00	4,125.00
Taxes [Payroll]	1,498.00	1,498.00
Professional Services	17,743.00	12,546.00
Telephone	635.00	635.00
Services and Supplies	7,153.00	5,580.00
Miscellaneous	12,568.00	1,754.00
Total Deductions	61,139.00	43,555.00
Taxable Income	$41,514,814.00	$6,784,804.00

153. In 1991, in addition to the royalties that it received from Sherwin-Williams, SWIMC received approximately $33,332.00 from its third-party licensees. During 1991, DIMC received royalties from Sherwin-Williams and Dupli-Color. It received $761,301.00 in royalties from Dupli-Color.

154. In 1991, there were approximately 1,000 companies in the United States competing in the coatings industry at the national, regional and local levels. Sherwin-Williams competed at all three levels. Its principal national competitors, among others, in the Paint Stores segment were Benjamin Moore & Co., Glidden and PPG Industries, Inc. At the national level, Sherwin-Williams Automotive Division competed with BASF, PPG Industries, Inc. and Du Pont.

155. During 1991, company-operated paint and wall covering stores in 48 states and Canada made up the Paint Stores segment which included the Paint Stores group and a Canadian Division. At that time, the Paint Stores group consisted of the following five geographical

divisions: the Mid Central Division which had 524 stores located primarily in the midwestern states; the Eastern Division which had 377 stores located along the upper east coast and in New England; the Southeastern Division which had 481 stores located principally in the lower east and gulf coasts; the South Central Division which had 393 stores located in Texas and the plains; and the Western Division which had 198 stores located primarily in Arizona, Colorado, Nevada, Utah and along the west coast. The Canadian Division included 8 stores in Ontario.

156. A review of the notes to the financial statements attached to petitioner's 1991 Annual Report indicates that inter-divisional "transfers are accounted for at values comparable to normal unaffiliated customer sales."

157. In 1991, Sherwin-Williams celebrated its 125th anniversary of doing business. That same year also marked Sherwin-Williams' 100th year doing business in New York State.

The Audit

158. Petitioner files its New York corporation franchise tax report on a separate basis. On December 14, 1992, the Division commenced a field audit of petitioner's reports for the years 1989 through 1991. Joseph Porempski, an auditor in the Buffalo District Office, conducted that audit.

159. In the field audit narrative, Mr. Porempski stated that Sherwin-Williams' "New York activity includes 68 stores in leased facilities and independent dealers."

160. Mr. Porempski did not testify at the hearing. Rather, his corporation tax audit team leader, Jeffrey Pragel, testified about the conclusions reached in the audit.

161. Based on Mr. Porempski's investigation, the Division concluded that petitioner should be required to file on a combined basis with SWIMC and DIMC. The Division found that

two of the three requirements for combination were met. First, Sherwin-Williams owns, directly or through another subsidiary Dupli-Color, 100 percent of the stock of SWIMC and DIMC and therefore satisfies the stock ownership requirement. Second, petitioner and its subsidiaries SWIMC and DIMC are operated as a unitary business. In addition, the Division found that there were substantial intercorporate transactions between both SWIMC and DIMC and petitioner, since almost all of their income was from transactions with petitioner, giving rise to the presumption of distortion.

162. Initially, Mr. Porempski concluded that all of SWIMC's trademarks were licensed to Sherwin-Williams and its subsidiaries, which conclusion is reflected in the narrative section of the field audit report.

163. However, the Division later learned that SWIMC and DIMC had third-party transactions during an informal conference held in the Buffalo District Office on August 23, 1995.

164. Prior to the conference, in April 1994, petitioner supplied the Division with a copy of the AAA appraisal report that determined the royalty rates.

165. After the informal conference, the auditor concluded that a combined report was appropriate after determining that petitioner had not rebutted the presumption of distortion arising from the substantial intercorporate transactions.

166. As an additional ground for requiring the combination in this case, the Division concluded that Sherwin-Williams' assignment of its trademarks to SWIMC and DIMC and their license back of those trademarks to Sherwin-Williams resulted in mismatching of the income and

expenses. The Division also concluded that the assignment and license-back transactions did not have economic substance.

167. During the course of the audit, a total of nine consents, extending the period of limitation for assessment of corporation franchise tax for January 1, 1989 through December 31, 1991, were executed by petitioner. Petitioner, by Dennis J. Moir, executed the last consent having the effect of extending the period of limitations for assessment of corporation franchise tax for the period January 1, 1989 through December 31, 1991 to February 15, 1997.[9]

168. Following the August 23, 1995 informal conference, several unsuccessful attempts were made to resolve this case.

169. On December 11, 1996, Mr. Porempski sent a letter to petitioner requesting the opportunity to interview the officers of SWIMC and DIMC.

170. Shortly thereafter, the case was sent to Albany for issuance of a notice of deficiency. The schedules containing the computations of the tax due based on the combination of Sherwin-Williams with SWIMC and DIMC are not part of the record, nor are the computations of additional tax due with respect to the other uncontested audit changes.

171. As noted in Finding of Fact "1," the Division issued the Notice of Deficiency on January 13, 1997.

172. Mr. Pragel testified that, with the exception of a few small dollar amount cases, forced combination was pursued by the Division in every audit where a corporation paid royalties to an intangible holding company affiliate.

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[9] Mr. Moir's signature is undated.

173. In the Case Preparation Worksheet prepared by the auditor prior to the Bureau of Conciliation and Mediation Services conference, Mr. Porempski indicated that documentation was not a factor in the audit.

Petitioner's Expert Witnesses

174. Mr. Spiro Bereveskos, a partner with the Indiana law firm of Woodard, Emhardt, Naughton, Moriarty and McNett, which specializes in intellectual property law, testified as to trademark law and his involvement in SWIMC's litigation against National Waterproofing in the trademark opposition proceeding.

175. Mr. Bereveskos is admitted to practice before the U.S. Patent and Trademark Office and has been involved in hundreds of intellectual property matters. He has lectured and published articles on intellectual property law, is on the advisory board of the professional publication "The IP Litigator" and is the past chairman of the Indianapolis Patent, Trademark and Copyright Association. Mr. Bereveskos was accepted as an expert in trademark and intellectual property law.

176. In the summer of 1991, Mr. Bereveskos was retained by SWIMC to represent it before the U.S. Patent and Trademark Office in the opposition proceeding against National Waterproofing. He had no involvement in the matter prior to SWIMC's ownership of the Marks.

177. During the National Waterproofing proceeding, the documentation showing the transfer of the Marks from Sherwin-Williams to SWIMC and the license of the Marks from SWIMC to Sherwin-Williams were produced. National Waterproofing never asserted a claim that the assignment of the Marks from Sherwin-Williams to SWIMC or the license from SWIMC to Sherwin-Williams constituted a naked assignment or a naked license. Ultimately, National

Waterproofing withdrew its registration application and discontinued its use of the image resembling the "Dutch Boy." SWIMC paid Mr. Bereveskos for his services.

178. Based upon his review of the pertinent documentation, his firsthand knowledge of SWIMC and the testimony at the hearing, Mr. Bereveskos concluded that the assignments and licenses between Sherwin-Williams and SWIMC and DIMC were valid and were not "naked."

179. Mr. Bereveskos also concluded, based upon the testimony he heard and the documentation he had reviewed, that a naked license defense to an action brought by SWIMC or DIMC would not succeed because the licensees were required to maintain certain standards and compliance with those standards was monitored by SWIMC and DIMC.

180. Having SWIMC and DIMC hold the Marks provides substantial benefits from a trademark law perspective. For example, if a third-party licensee of SWIMC and DIMC produced defective merchandise, Sherwin-Williams would be insulated from a lawsuit brought against SWIMC and DIMC. Sherwin-Williams' officers would not be deposed and its financial information would not be obtainable.

181. Judgments docketed against SWIMC or DIMC could not be satisfied by attaching Sherwin-Williams' assets. It would be easier to transfer stock in SWIMC or DIMC than to re-register all the Marks that they own.

182. According to Mr. Bereveskos, it is becoming commonplace for corporations to be created to own and license intellectual property because of the benefits that are obtained by having a separate affiliated corporation own and license intellectual property. Benefits include better focus upon management of the intellectual property and insulation of the parent corporation from claims arising from licensing the intellectual property to third parties.

183. Royalties are routinely charged when there are licenses between affiliates.

184. Mr. Bereveskos' firm has recommended the formation of trademark protection companies to its clients. Intellectual property concerns and not potential tax benefits motivated the recommendations. In fact, Mr. Bereveskos' firm does not have any tax attorneys and has no expertise in tax matters.

185. At the hearing, petitioner presented the testimony of Professor Richard D. Pomp, and submitted into evidence a report prepared by Professor Pomp.

186. Professor Pomp holds a J.D. from Harvard Law School and a B.S. from the University of Michigan. He is the Alva P. Loiselle Professor of Law at the University of Connecticut, is an Adjunct Professor of Law at both New York University School of Law and Columbia Law School and is a visiting Professor at Harvard Law School. He has published a casebook (with Oliver Oldman), State and Local Taxation, that is used by law schools, accounting firms and corporations. He was the Director of the New York State Tax Study Commission from 1982 through 1987. Professor Pomp has been retained as a consultant by the Department of Justice, the U.S. Treasury Department, the Internal Revenue Service, the Multistate Tax Commission, and the states of New York, Utah, Louisiana, Illinois, North Dakota, Texas, Montana, Tennessee and Connecticut. Professor Pomp was accepted as an expert on state tax policy.

187. Professor Pomp opined that, from a policy perspective, Sherwin-Williams should not be required to file on a combined basis with either SWIMC or DIMC.

188. Professor Pomp, after recognizing that "[i]n this business there is the good, bad and ugly," and that, within that spectrum, the instant matter presented "as strong a factual pattern [for

the taxpayer] as any that [he has] encountered personally," concluded that "there was no justification for imposing a combined report that included SWIMC, DIMC and Sherwin-Williams."

189. The due diligence Professor Pomp conducted included his review of Sherwin-Williams' annual reports, financial statements, the license agreements, discussions with employees of Sherwin-Williams, SWIMC and DIMC, the petition and answer and hearing the testimony of the other witnesses during the hearing.

190. In Professor Pomp's opinion, the primary goal for forming SWIMC and DIMC "was to impose some order on what was otherwise a disorganized system or lack of system for managing Sherwin-Williams' intellectual property." His conclusion was based upon his recognition of the business purposes that are served by such separate entities. Those business purposes included the segregation of the aerosol Marks into DIMC to allow for the monitoring of aerosol sales, the protections afforded Sherwin-Williams from claims arising from the Marks, and the additional quality control separate from production that was achieved.

191. Professor Pomp concluded that if tax purposes were the sole motivation for creating SWIMC and DIMC, then Sherwin-Williams would have transferred its foreign marks and all of its patents to SWIMC and DIMC to increase the royalties that it could pay.

192. Professor Pomp stated that ***Moline Properties, Inc. v. Commissioner*** (319 US 436, 87 L Ed 1499), set forth the threshold needed to establish business purpose and that the requisite threshold is very low. There was no question in Professor Pomp's mind that SWIMC and DIMC met the threshold and should be respected as separate corporate entities.

193. Professor Pomp posited, moreover, that whether a separate entity is created on a whim, and even without a business purpose, should not affect the ultimate determination of whether it has substance.

194. Professor Pomp discussed New York State's long-standing policy not to have the California method of combined reporting. California only requires that there be a sufficient ownership interest and a unitary relationship in order for corporations to be permitted or required to file on a combined basis. In New York, the separate existence of a parent and subsidiary is respected unless there is a need to remove distortion or to clearly reflect income.

195. Professor Pomp explained that combined reporting is necessary in New York only when the separate entity structure does not result in a proper reflection of the taxpayer's income.

196. Professor Pomp also addressed the issue of whether there is any mismatching of income and expenses caused by Sherwin-Williams' payments of substantial advertising expenses. He pointed out that the advertising expenses are incurred by Sherwin-Williams to sell its products and those expenses would be incurred by Sherwin-Williams regardless of which entity owned the Marks. For example, Sherwin-Williams also licenses trademarks from Martha Stewart and Ralph Lauren and incurs advertising expenses to increase its sales of products bearing those trademarks. Mr. Ault confirmed that Sherwin-Williams advertises for products that it produces under third-party licenses, such as those with Martha Stewart and Ralph Lauren.

197. Under the Federal tax law, advertising expense is allowed as a deduction in the year incurred because of the recognition that advertising expenses are primarily incurred to sell products. The fact that there may be an indeterminate contribution to the value of the

trademarks, be they SWIMC's, DIMC's, Martha Stewart's or Ralph Lauren's, does not constitute mismatching.

198. Professor Pomp testified that it is not reasonable to expect enormous amounts of expenses to be incurred by service-oriented businesses, such as SWIMC and DIMC. The more appropriate inquiry is whether SWIMC and DIMC are realizing reasonable rates of return on their assets.

199. Professor Pomp reviewed Mr. Richard Genetelli's separate accounting report. Based upon his application of the relevant case law, including ***Han Rees' Sons v. North Carolina*** (283 US 123, 75 L Ed 879), ***Container Corp. of America v. Franchise Tax Board*** (463 US 159, 77 L Ed 2d 545), and ***Moorman Manufacturing Co. v. Bair*** (437 US 267, 57 L Ed 2d 197), Professor Pomp concluded that the Division's's assertion of tax against Sherwin-Williams is unconstitutional.

200. Professor Pomp found that the U.S. Supreme Court cases made clear that, if a state seeks to tax by formulary apportionment in excess of 250% of the income as determined by separate accounting, such imposition is unconstitutional.

Since imposition of a combined report that includes Sherwin-Williams, SWIMC and DIMC results in a tax that is 550% of the tax as determined by a separate accounting, Professor Pomp concluded that the Division's assertion of tax against Sherwin-Williams is unconstitutional.

Transfer Pricing Analysis

201. Grant Thornton, one of the largest accounting and management consulting firms in the United States, was retained by Sherwin-Williams to determine whether the three

intercompany transactions between Sherwin-Williams and SWIMC and DIMC - - (1) the license of the Marks by SWIMC and DIMC to Sherwin-Williams; (2) the loan made by SWIMC to Sherwin-Williams; and (3) the provision of legal services by Sherwin-Williams to SWIMC and DIMC (together the "Transactions") - - were at arm's length rates and to prepare a transfer pricing report detailing its findings.

202. Mr. Per Hasenwinkle, a senior manager at Grant Thornton, was responsible for the study and the preparation of the report. He has over 10 years experience with transfer pricing and IRC § 482, and has prepared in excess of 100 transfer pricing studies. Mr. Hasenwinkle was accepted as an expert in transfer pricing, economics and IRC § 482. He testified as to the methodologies used and the conclusions reached in the study. Mr. Hasenwinkle concluded that the Transactions were at arm's length rates.

203. The study was memorialized in a transfer pricing report that applied the documentation rules under IRC § 6662. In performing the study, Mr. Hassenwinkle and his team applied the standards set forth in IRC § 482 and the regulations adopted by the U.S. Treasury Department in 1994. Although the year in issue here is 1991, Treasury Regulation § 1.482-1(j) provides that the 1994 regulations can be used for all open years.

204. In preparation of the study, Mr. Hasenwinkle and his team reviewed a broad range of quantitative and qualitative internal and external documentation including, among other things, annual reports, Forms 10-K,[10] product brochures, and intercompany agreements for Sherwin-Williams, SWIMC and DIMC. The Grant Thornton team also reviewed annual reports and Forms

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[10] A Form 10-K is an annual report required to be filed with the Securities and Exchange Commission pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934.

10-K for comparable companies and industry association literature. Numerous discussions were had with Sherwin-Williams' personnel in each of its operating divisions as well as with Dr. Puglisi, SWIMC's and DIMC's president.

205. Mr. Hasenwinkle explained the analysis used in the transfer pricing study. The first step taken was the performance of a functional analysis, one of the primary tools used by economists in analyzing a company. This analysis looks to the functions a company performs in bringing a product to the market. A functional analysis is used to develop a profile that can be used to identify companies that are comparable to the company that is being analyzed. Then a risk analysis is performed to determine the risks assumed by the company in performing its functions.

Next, the tested party is chosen by determining which of the related companies that is involved in the intercompany transactions at issue is the easiest to analyze. Under the IRC § 482 regulations, the party to evaluate in order to determine whether intercompany prices are at arm's length is generally the party for which data: (1) are the most complete, (2) are the most reliable and can be easily verified, and (3) require the fewest adjustments. In most cases, the party to an intercompany transaction to be evaluated is the simplest of the entities involved (i.e., performs the least complex functions), and is the one that does not own valuable, non-routine intangible property or other unique assets that distinguish it from potentially comparable uncontrolled companies. After the tested party is chosen, a decision is then made as to which method for analyzing the related transactions is the best.

206. The selection of the best method depends on a number of factors such as: the availability of complete and reliable data; the degree of comparability between controlled and

uncontrolled companies (or transactions); and the number, magnitude and accuracy of adjustments necessary to apply the method. Four transfer pricing methods are available for evaluating intercompany transfers of intangible property: the Comparable Uncontrolled Transaction method, the Comparable Profits Method, the Profit Split Method and "Unspecified" methods.

The Comparable Uncontrolled Transaction method ("CUT") evaluates whether the amount charged for a controlled transfer of intangible property is arm's length by reference to the amount charged in a comparable uncontrolled transaction (Treas Reg § 1.482-4[c][1]). The Comparable Profits Method ("CPM") evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators or "PLIs") derived from uncontrolled parties that engage in similar business activities under similar circumstances (Treas Reg § 1.482-5[a]). The Profit Split Method ("PSM") evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled party's contribution to the combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled parties for which data is available that includes the controlled transactions (relevant business activity) (Treas Reg § 1.482-6[a]). The "Unspecified" method must be applied in accordance with the provisions of Treas Reg § 1.482-1 and should take into account the general principle that uncontrolled parties evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it (Treas Reg § 1.482-4[d][1]).

207. Comparable companies are then selected based upon whether they perform similar functions and assume similar risks to those of the tested party. The profitability of the comparable companies is then evaluated and adjustments are made to account for differences between the tested party and the comparables.

Analysis of Royalty Rates

208. In performing the transfer pricing study regarding the royalties paid by Sherwin-Williams to SWIMC and DIMC, the functional analysis separately examined each of Sherwin-Williams' operating divisions, i.e., Automotive, Consumer,[11] Specialty, Paint Stores[12] and Transportation, and SWIMC and DIMC, to determine the functions each performed and the risks each assumed. The operating divisions were examined rather than Sherwin-Williams as a single entity because the examination of the most narrowly defined business segment within the company increases the reliability and accuracy of the study. The risks identified by the IRC § 482 regulations (e.g., market risks, management risks and financial risks) were then analyzed for Sherwin-Williams' operating divisions and for SWIMC and DIMC.

209. Mr. Hasenwinkle noted that, under an IRC § 482 analysis, if a company had no economic substance it would perform no functions and would assume no risks. Since SWIMC and DIMC performed several functions (e.g., protecting and managing their respective Marks and investing their funds), and assumed risks (e.g., market and financial risks) Mr. Hasenwinkle concluded that each corporation had economic substance.

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[11] The operations of the Chemical Coatings Division, which was dissolved during the 1991 fiscal year, were included in the Consumer Division.

[12] The operations of International (Domestic) and Canadian Paint Stores divisions were included in the Paint Stores Division.

210. Based on the functional analysis, Sherwin-Williams' operating divisions were determined to be the tested parties.

211. The Grant Thornton report set forth the royalty payments received by SWIMC and DIMC in table form, as follows:

Sherwin-Williams Divisions	SWIMC Royalty Income	DIMC Royalty Income
Automotive	$11,170,864.00	-0-
Consumer	4,710,705.00	-0-
Specialty	215,063.00	4,643,516.00
Stores	25,261,622.00	1,390,943.00
Transportation	-0-	-0-
Total	$41,358,254.00	$6,034,459.00

212. After analyzing the methods available under the IRC § 482 regulations for testing whether rates for use of intangible property are at arm's length, Mr. Hasenwinkle determined that the CPM was the best method for analyzing the arm's length nature of the royalties being paid by Sherwin-Williams for its use of SWIMC's and DIMC's Marks. The CUT method was not chosen because neither internal nor external comparable licensing transactions could be identified. Both the comparable and residual PSMs were considered and rejected as the best method for evaluating SWIMC's and DIMC's intercompany transfer prices with Sherwin-Williams. Grant Thornton was unable to identify any unrelated parties satisfying the requirements necessary to apply the comparable PSM. After analyzing Sherwin-Williams' and SWIMC's and DIMC's operations, Grant Thornton determined that SWIMC and DIMC were the

only parties that owned significant intangible assets related to the intercompany transactions being evaluated to warrant the use of the residual PSM.

213. Next, a search for independent companies that performed manufacturing and distribution functions similar to those performed by Sherwin-Williams' operating divisions was conducted. The goal of the search was to identify independent comparable companies that could be used in profitability analyses to determine the arm's length level of profit that Sherwin-Williams' operating divisions should generate on their manufacturing, distribution and transportation activities. Two financial databases, the Disclosure Compact D SEC and Standard & Poor's Compustat (North America), were searched using the Standard Industrial Classification ("SIC") codes applicable to Sherwin-Williams' divisions. The SIC codes are the way the United States government effectively sectors the United States economy into different industries. As a second step, the list of potentially comparable companies derived in this manner was then winnowed by eliminating those companies for which financial data for the years 1989 through 1991 was unavailable. That screening criteria was required to: eliminate startup and inactive companies; to provide sufficient historical data to even out one-year aberrations in financial results; and to normalize the effects of product or business cycles. The third step was to examine the companies to determine to what extent, if any, they engaged in activities generally associated with the development of intangible assets, such as research and development ("R&D") or marketing and promotional activities. Companies that were determined to commit significant resources to those functional areas were eliminated from the sample, because capital invested in R&D and promotional activities is inherently more risky than capital invested in basic manufacturing activities, due to the uncertainty of the economic outcome from those activities.

The level of R&D and marketing expenditures were evaluated according to three factors: (1) excessive market value relative to book value, (2) extraordinary R&D relative to sales, and (3) material importance placed on trademarks in the comparable company's SEC Form 10-K report. A company that failed two of these three criteria was eliminated from the sample. Under this step, companies were excluded, such as Benjamin Moore, that owned significant intangibles and whose expected profits would be greater because of the inclusion of those intangibles. Lastly, a functional and product comparability analysis was then performed. Companies that (1) were not manufacturers, (2) did not sell to the same market level, (3) did not utilize a similar sales channel, or (4) did not produce a similar product were eliminated. Companies were also evaluated on the basis of other factors that would distort the returns represented on the company's financial reports. Those additional factors included: (1) the occurrence of a merger, acquisition, or dissolution, (2) bankruptcy proceedings, or (3) viability as a going concern or companies with material financial or legal liabilities. When Sherwin-Williams appeared in a comparable company search result, it was not included in the sample. The results of both the functional analysis and the application of the above-described search process for each operating division are set forth below.

214. The Automotive Division was determined to be primarily engaged in the manufacture of after-market automotive finishes that are sold to vehicle repair shops, production shops, and distributors/jobbers. It also produces exterior finishes for tractor trailers and interior finishes for automotive components that are sold to heavy duty fleet and storage equipment OEMs. It was also determined that the two principal product lines are sold directly to four target

consumers (i.e., vehicle repair shops, distributors/jobbers, production shops and OEMs) by approximately 450 sales employees.

215. Although, in 1991, the Automotive Division's products were also marketed through 154 "company-operated" automotive branches that generated approximately 50% of that division's sales, it is not mentioned in the functional analysis. Even though Mr. Hasenwinkle was unaware that the Automotive Division had automotive branches, he stated that it was irrelevant for the transfer pricing analysis because the selection of comparables would remain the same since the primary function of the Automotive Division is manufacturing. He also noted that there is no breakdown between the manufacturing segment and the distribution segment of the Automotive Division. On cross-examination, Mr. Ivy confirmed that, for competitive reasons, Sherwin-Williams did not do analysis of the Automotive Division's sales.

216. SIC codes 2851(for companies that manufacture paint, varnishes, lacquers, enamels and allied products) and 2842 (for companies that manufacture specialty cleaning, polishing and sanitation preparation type products) were used for the Automotive Division search that produced a total of 36 companies. The financial data screen reduced the initial sample by 15, leaving 21 companies for further research. The intangible assets screen reduced the set by 2 companies, while the final functional and product evaluation eliminated 15 additional companies, leaving a final set of 4 companies consisting of Grow Group, Inc., Lilly Industries, Inc., PPG Industries Inc., and RPM Inc.

217. The Consumer Division was determined to manufacture interior and exterior architectural coatings which are sold directly to retailers for resale to the do-it-yourselfer market. It also produces marine and industrial coatings. Each of its four primary product groups, "Dutch

Boy," "Martin-Senor," Private Label, and National Accounts, target a different segment of the retail market. "Dutch Boy" paints are sold at wholesale to hardware stores and homebuilders and are also sold through K-Mart outlets bearing a joint K-Mart/Dutch Boy logo. "Dutch Boy" sales to K-Mart are coordinated through the National Accounts Group. "Martin-Senour" products are sold exclusively to independent paint dealers. All private-label brands are sold under marks designated by the retailers as their in-house brand. National Accounts sells "Kem-Tone" products to national discount chains and other paint products private-labeled on behalf of the purchaser, usually a mass merchandiser. The end-user of all of the Consumer Division's products is the do-it-yourselfer or small contractor who is price conscious.

218. For the Consumer Division, SIC code 2851 (for companies that manufacture paint, varnishes, lacquers, enamels and sealers) was chosen. One additional company, with a 2899 primary SIC code (Compact D SEC), which had been rejected from the search conducted for the Specialty Division, was added to the initial search. The initial search produced a total of 25 companies. The financial data screen reduced the sample by 12, leaving 13 companies for further scrutiny. The intangible assets screen reduced the set by one company, while the final functional and product evaluation eliminated five companies, leaving a final set of eight companies consisting of Ferro Corp., Grow Group, Inc., Guardsman Products Inc., Lilly Industries Inc., PPG Industries, Inc., Pratt & Lambert Inc., RPM, Inc. and the Valspar Corp..

219. The Specialty Division was determined to manufacture and distribute paint applicators and aerosol spray paints for sale to mass merchandisers and independent paint and hardware stores. It also manufactures various lubricants and cleaners for sale to distributors and commercial users. Five key business segments are served by the Specialty Division's products:

(1) general retail, (2) automotive, (3) industrial, (4) custom, and (5) specialty. The general retail, automotive and specialty segments sell directly to hardware stores, national retail chains and mass merchandisers for resale to the do-it-yourself retail market. The industrial and custom segments sell to the industrial or maintenance end-user.

220. For the Specialty Division, SIC codes 2851 (for companies that produce paints, varnishes, lacquers, enamels, and allied products), 2842 (for companies that manufacture specialty cleaning, polishing and sanitation products) and 2899 (for companies that produce miscellaneous application chemicals) were chosen. The search produced a total of 61 companies for further research. The financial data screen reduced the sample by 29, leaving 32 companies for further scrutiny. The intangible assets screen reduced the set by 3 companies, while the functional and product screen eliminated 24 companies, leaving a final group of 5 companies consisting of Arrow Magnolia Intl. Inc., Grow Group Inc., Guardsman Products, Inc., Ocean Bio Chem Inc. and Specialty Chemical Resources Inc.

221. The record includes photocopies of portions of the Forms 10-K and annual reports for a number of the companies chosen by Grant Thornton for the five operating divisions.[13]

222. According to its Annual Report, PPG Industries Inc. ("PPG") is comprised of three basic business segments: glass, coatings and resins, and chemicals. It is one of the major producers of flat glass, fabricated glass and continuous strand fiber glass in the world. In 1991, approximately 39% of its net sales came from the production of glass. PPG is a major producer of protective and decorative coatings. According to PPG's 1991 Annual Report, it is the "world's leading supplier of automotive and industrial finishes" and a "major supplier of

[13] Some of the photocopies are barely legible.

architectural finishes." Sherwin-Williams is identified, in that Annual Report, as one of PPG's major competitors in the supply of coating products for automotive manufacturing and repair; commercial and residential construction and maintenance; and factory finishing of various industrial, construction and consumer products. In 1991, approximately 39% of its total net sales came from the production of coatings and resins.

The industrial portion of its coatings business involves the supply of protective and decorative finishes for automobiles, appliances, industrial equipment, and containers; factory finished aluminum extrusions and coils for architectural uses; and other industrial and consumer products. In addition to supplying finishes to the automobile OEM, PPG supplies automotive refinishes to the aftermarket which are primarily sold through distributors.

PPG's architectural finishes business consists primarily of coatings used by painting and maintenance contractors and by consumers for decoration and maintenance. Its products are sold through independent distributors, paint dealers, mass merchandisers and home centers.

223. Lilly Industries, Inc. ("Lilly) is principally engaged in the business of manufacturing and selling industrial coatings (including enamels, varnishes, lacquers, gelcoats, silver solutions and similar coatings) to other manufacturing companies. Lilly's products include liquid and powder coatings used by a variety of manufacturers to coat wood, plastics and metal substrates. It manufactures, among other things, wood coatings for furniture, flooring, kitchen cabinets and paneling; coil coatings for appliances, aluminum residential siding and components, automotive parts, doors, windows and metal buildings; general metal coatings for a broad range of metal products, including aluminum extrusions, appliances, caskets, office furniture, and truck trailers; automotive refinishes and trade sales coatings. According to the Annual Report, Lilly's

automotive refinishes are "distributed mainly to repair shops and fleet users" and its trade sales coatings are "sold primarily to professional contractors and homeowners."

224. According to its Form 10-K and Annual Report, Grow Group, Inc. ("Grow Group") "is one of America's foremost producers of specialty chemical coatings and paints, pool and spa products and detergents, maintenance and cleaning products for household, professional and industrial use throughout the world." Grow Group consists of two operating groups: coatings and chemicals and consumer and professional products. In 1991, the coatings and chemicals group accounted for 69% of Grow Group's total net sales, with the remaining 31% attributable to the consumer and professional products group.

In its coatings and chemical group, Grow Group produces architectural coatings, automotive and industrial products, and maintenance and marine coatings. Grow Group produces and markets protective and decorative water and solvent thinnable trade or general purpose paints and coatings (enamels, varnishes and stains) as well as interior and exterior waterproof coatings, for use by painting contractors, industrial and commercial users and the general public for the interior and exterior of homes, buildings and other structures. It also sells a variety of brushes, rollers, wallpaper and other decorating and painting equipment items purchased from others. The architectural coatings are marketed through more than 1,000 independent retail dealers and approximately 100 "company-operated" outlets. Its trade paint customers are primarily dealers and paint contractors with additional sales to retail consumers and industrial, institutional, commercial maintenance and private label accounts.

Grow Group's automotive products include solvents, thinners, paint strippers, adhesives and sealants used primarily by automotive manufacturers, their suppliers of component parts, the automotive after-market and "to a lesser extent, non-automotive customers." The automotive products are marketed primarily by Grow Group's salaried salesmen. Grow Group also produces and sells heavy duty, high performance coatings for industrial maintenance and marine applications.

Grow Group's consumer and professional products group manufactures swimming pool chemicals and a line of household laundry cleaning and industrial maintenance products. The household cleaning and professional products that the consumer and professional products group produces include soaps, detergents, floor finishes, furniture polishes, waxes and other chemicals and products for cleaning, waxing, buffing, stripping and maintaining clothing, walls, windows, floors and furniture. These products are marketed by hardware and drug stores, supermarkets, mass merchandisers, specialty home care centers, convenience stores and warehouse/club outlets. The consumer and professional products group also produces and sells a wide line of paint products and adhesives in aerosol spray dispensers (aerosol products).

225. According to its Annual Report, Ferro Corp. ("Ferro") manufactures three major specialty product lines: coatings, colors and ceramics; plastics; and chemicals. Ferro's specialty materials are used by manufacturers in a broad range of applications. The end markets that Ferro serves include, among others, building and renovation, major appliances, household furnishings, industrial products, transportation, packaging and leisure products. In 1991, sales of coatings, colors and ceramics accounted for 55% of Ferro's total sales. Ferro's specialty plastics segment manufactures color concentrates, gelcoats, paste colors, liquid and dry colors; filled and reinforced plastics and engineering thermoplastics. Its specialty chemicals segment manufactures

polymer additives, fuel additives and friction modifiers, industrial chemicals, metalworking additives and flame retardants.

226. Petitioner's Paint Stores Division was determined to sell architectural, marine and industrial coatings through Sherwin-Williams paint stores. The paint stores are the exclusive seller of the "Sherwin-Williams" brand of interior and exterior house paint. The paint is sold at retail to do-it-yourselfers and wholesale to painting professionals, contractors and paint specifiers.[14] Industrial coatings, marine paints and specially-developed coatings resistant to harsh chemicals or toxic environments, are sold directly to industrial maintenance contractors. Specialty chemical coatings for the non-automotive original equipment manufacturer ("OEM") market are also sold by the division directly to manufacturers. OEM products include, among other things, metal office furniture, aluminum siding and computer housings.

227. The search for comparable companies was slightly different for the operating divisions that performed distribution functions, specifically the Paint Stores Division and the Transportation Division, rather than manufacturing functions. Based on conversations with Sherwin-Williams personnel and review of Sherwin-Williams' Form 10-K, Grant Thornton determined that the wholesale market accounted for approximately 80% of the Paint Stores Division's sales and the retail market accounted for 20% of its sales. Since the Paint Stores Division performed two functions, a wholesale distribution function and a retail distribution function, which sold to different market levels, two searches were conducted. To identify wholesale distribution companies that distribute paint and related equipment, the search focused

[14] A paint specifier is an owner, architect, or other person who indicates which paint should be used by the painter for a particular project or series of projects.

on companies that were categorized under the primary SIC codes 5023 (for distributors of home furnishings); 503 (for distributors of lumber and other construction materials) 5051 (for distributors of metals service centers and offices); 5063 (for distributors of electrical apparatus and equipment, wiring supplies and construction materials); 5072 (for hardware distributors); 5074 (for distributors of plumbing and heating equipment and supplies [hydronics]); 5075 (for distributors of warm air heating and air-conditioning equipment and supplies); 5198 (for distributors of paints, varnishes, and supplies); 5211 (for distributors to lumber and other building materials dealers); 5231 (for distributors to hardware stores); 5261 (for distributors to retail nurseries, lawn and garden supply stores); 5713 (for distributors to floor covering stores); and 5714 (for distributors to drapery, curtain and upholstery stores). The SIC code search identified 168 companies. An initial screening out of companies that did not have adequate financial data and developed or owned intangible assets eliminated 91 companies, leaving 77 companies for further consideration. To identify retail distribution companies that distribute paint and related equipment, the following SIC codes were used: 5211 (for lumber and other building materials dealers); 5251 (for hardware stores); 5261 (for retail nurseries, lawn and garden supply stores); 5713 (for floor covering stores) and 5714 (for drapery, curtain and upholstery stores). The initial SIC code search identified 56 companies. The initial screening, for inadequate financial data and the development or ownership of intangible assets, eliminated 30 companies, leaving 26 companies for further review.

228. The final step in the search for comparable wholesale and retail distribution companies eliminated those companies that did not distribute through sales channels and at market levels similar to those of the Paint Stores Division. In addition, companies that owned

valuable intangible property, such as patents, trademarks or trade names, deemed critical to their business enterprise were disqualified from inclusion in the final set of comparable companies. This final functional and product comparability examination rejected 73 additional wholesale distribution companies and 20 additional retail distribution companies, leaving a final set of 4 wholesale distributors and 6 retail distributors. The wholesale distribution comparables were: Hughes Supply Inc., Noland Co., Payless Cashways Inc., and Strober Organization Inc.. The retail distribution comparables were: Color Tile Inc., Grossman's Inc., Hechinger Co., Lowe's Cos. Inc., NHD Stores Inc.,and Wolohan Lumber Co..

229. According to the Form 10-K and the Annual Report for Hughes Supply Inc. ("Hughes") for the fiscal year ended January 31, 1992, it is primarily engaged in the wholesale distribution of a broad range of materials, equipment and supplies to the construction industry and the mechanical and electrical trades. Its customers are subcontractors, electric utilities, municipalities and industrial accounts. Hughes distributes more than 85,000 different products through 117 wholesale outlets in Florida, Georgia, North Carolina, South Carolina, Tennessee, Kentucky, Mississippi, Maryland and Alabama. According to the Form 10-K, on the basis of its total sales, Hughes is the largest wholesale distributor of its range of products in the Southeast. For the fiscal year ended January 31, 1992, net sales were $481,001,000.00.

230. According to the Annual Report for the Noland Company ("Noland") for the fiscal year ended December 31, 1991, it is one of the nation's leading independent wholesalers with 92 branches in the following 13 southern states: Alabama, Arkansas, Florida, Georgia, Kentucky, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Texas, Virginia and West

Virginia. Noland sells a wide variety of products to nearly 34,000 customers. For the fiscal year ended December 31, 1991, Noland's net sales were $384,535,000.00.

231. According to the Form 10-K for Payless Cashways, Inc. ("Payless") for the fiscal year ended November 30, 1991, it operated 195 retail stores in the following 26 states: Arizona, Arkansas, California, Colorado, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee and Texas. Each of Payless's retail stores is designed as a one-stop shopping center to provide greater convenience for the serious do-it-yourselfer and the professional customer. Payless sells a broad range of building material products. For the fiscal year ended November 30, 1991, Payless's net sales were $2,387,235,000.00.

232. According to the Form 10-K for the Strober Organization Inc. ("Strober") for the fiscal year ended December 31, 1991, it is a supplier of building materials that served professional contractors out of ten building supply centers, two Kitchen and Bath centers and three Peachtree Planning centers, with a total of approximately 452,700 square feet of covered space, in New York, New Jersey, Connecticut and Pennsylvania. For the fiscal year ended December 31, 1991, Strober's net sales were $90,150,000.00.

233. According to the Form 10-K for Color Tile Inc. ("Color Tile") for the fiscal year ended December 29, 1991, it operates specialty retail stores serving do-it-yourself, buy-it-yourself, and commercial customers in 48 states in the United States and in 7 provinces in Canada. In 1991, Color Tile had a total of 770 stores and 13 franchised store locations. In the United States, 725 stores were operated under the name "Color Tile" and 6 stores were operated

under the name “Peerless.” In Canada, 39 stores were operated under the name “Factory Carpet.” The products sold through Color Tile’s stores include hard surface tiles, such as ceramic, mosaic and quarry tile, wood flooring, resilient flooring, carpeting, wall coverings, window treatments, installation materials and tools, and related installation services. For the fiscal year ended December 29, 1991, Color Tile’s net sales were $544,315,000.00.

234. Grossman’s Inc. (“Grossman’s”) is a retailer of lumber, building materials, and other home improvement products. In 1991, it operated 139 stores, in the six New England states, New York, New Jersey, Pennsylvania and California. Grossman’s stores are one-stop shopping centers designed to supply customers with materials and tools necessary to carry out home improvement projects. According to the Form 10-K, historically, Grossman’s has recorded its highest sales level in the second and third quarters of the year. In 1991, Grossman’s net sales were $806,636,000.00.

235. According to the Annual Report for Hechinger Company (“Hechinger”) for the fiscal year ended February 2, 1991, it is a leading specialty retailer providing products and services for the care, repair, remodeling and maintenance of the home and garden. At that time, it served the home improvement industry through three separate operations: Hechinger, whose 84 stores served do-it-yourselfers from the Carolinas to Connecticut and as far west as Ohio; Home Quarters Warehouse (“HQ”), with 28 stores up and down the east coast; and Triangle Building Centers, with 6 stores that covered mid-eastern Pennsylvania. Hechinger stores offer expert advice and a full range of building material and home improvement merchandise to customers. HQ stores follow the warehouse format and bring a “powerful assortment” of building supply

products to the do-it-yourself and professional home repair and remodeling customers. For the fiscal year ended February 1, 1992, Hechinger's net sales were $1,607,727,000.00.

236. According to the Annual Report for Lowe's Cos. Inc. ("Lowe's) for the fiscal year ended January 31, 1991, it is a specialty retailer in the do-it-yourself home center business, the consumer durables business and the building contractor business. In 1990, Lowe's had 309 stores located principally in the South Atlantic and South Central regions of the United States. At that time, its stores served customers in the following 20 states: Alabama, Arkansas, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maryland, Mississippi, Missouri, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, and West Virginia. Lowe's net sales for the fiscal year ended January 31, 1991 were $2,833,108,000.00. The Annual Report highlights the fact that in Fortune magazine's latest listing of America's top retailers, Lowe's ranked 43rd in sales; 27th in profits and 15th in total return to investors. The Annual Report also identifies that in Builders Supply Home Center's 1990 annual list of the top ten building supply/home center companies, Lowe's ranked number 2, Payless Cashways, Inc. ranked number 3, Hechinger Co. ranked number 5, and Grossman's ranked number 8.

237. According to the Form 10-K for NHD Stores, Inc. ("NHD") for the fiscal year ended January 25, 1992, it is engaged in the retail sale of hard goods items through individual hardware stores. In 1991, NHD operated 35 "NHD Super Hardware Stores" in five New England states. According to the Form 10-K, NHD's total sales for the fiscal year ended January 25, 1992, increased by 1.7% to $56,876,218.00.

238. According to the Form 10-K and the Annual report for Wolohan Lumber Co. ("Wolohan Lumber") for the fiscal year ended December 31, 1991, it is engaged in the retail sale of a full line of lumber and building materials and related items through a chain of 51 building supply stores located in the Midwest, specifically, Illinois, Indiana, Kentucky, Michigan, Missouri, Ohio and Wisconsin. Wolohan provides service to both "consumer/do-it-yourself" and professional contractor customers. According to the Form 10-K, Wolohan's business is subject to seasonal influences. The second and third quarters are generally the periods of highest sales volumes while the first quarter is usually the period of lowest sales volume. For the fiscal year ended December 31, 1991, Wolohan's sales increased 3% to a record $303,715,000.00.

239. The Transportation Division was determined to distribute and transport finished goods for the other operating divisions of Sherwin-Williams. The division's fleet of 350 Sherwin-Williams owned, self-insured trucks and trailers is licensed as a common carrier and engages in limited back hauling that represents 10% of fleet revenue. The remaining 90% of fleet revenue is generated from intercompany receipts. The fleet is allocated, according to distribution volume, among six regionally-located, domestic distribution service centers.

240. To identify independent trucking companies that transport general, non-hazardous, and non-perishable commodities, the search focused on companies that were categorized under the primary SIC codes 4212 (for local trucking services without storage); 4213 (for trucking services, except local); 4214 (for local trucking services with storage); and 4215 (for courier services, except by air). The SIC code search identified 83 companies. After screening out companies that: (1) did not have adequate financial data, (2) developed or owned intangible assets, and (3) did not perform distribution functions or transport products similar to those of the

Transportation Division, a final set of 18 transportation service companies was left. The transportation service comparables consisted of: American Freightways, Arnold Industries Inc., Builders Transport Inc., Cannon Express Inc., Central Freight Lines Inc., Chemical Leaman Corp., General Parcel Service Inc., Intrenet Inc., J B Hunt Transport Service Inc., M S Carriers Inc., NFC Plc, Old Dominion Freight Line Inc., OTR Express Inc., P A M Transportation Services Inc., Preston Corp., Swift Transportation Co. Inc., Transcon Inc., and Transit Group Inc..

241. Based on his experience in performing over 100 transfer pricing studies, Mr. Hasenwinkle concluded that the comparables identified for each of Sherwin-Williams' divisions were excellent comparables that were very strong from both a functional and industry perspective. The comparables chosen were "reliable proxies for evaluating the arm's-length profits of Sherwin-Williams' operating divisions."

242. Under the CPM, the arm's-length result is determined by the amount of operating profit that the tested party would have earned on the controlled transaction if its PLIs were equal to that of an uncontrolled comparable company. An arm's-length level of profit is calculated by applying the PLI of the comparable independent company to the financial data related to the controlled transactions. PLIs are ratios that measure the relationship between profits and costs incurred or resources employed. The IRC § 482 regulations provide that a variety of PLIs can be used in any given analysis. The choice of PLI depends upon a number of factors, including the activities of the tested party, the reliability of the data of the comparable uncontrolled companies, and the extent to which the indicator will produce a reliable measure of an arm's-length result. These PLIs include the rate of return on capital employed and various financial ratios. The

regulations also recommend that the PLIs should be derived from a period that encompasses at least the year under review and the two preceding years.

243. The rate of return on capital employed is defined as the ratio of operating profits to operating assets ("ROA"). The reliability of this PLI increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled comparable companies. In addition, the reliability of this PLI depends upon the extent to which the composition of the tested party's assets is similar to those of the uncontrolled comparables. Financial ratios measure the relationship between profit and costs or revenues, and are generally more sensitive to functional differences than the ROA. Therefore, closer functional comparability is required when applying a financial ratio PLI. Financial ratios that may be employed include, among others, ratio of operating profit to sales and ratio of gross profit to operating expenses.

244. Each comparable company's profitability for 1989, 1990 and 1991 as well as the three-year average was calculated. Grant Thornton also calculated the profitability of each of the five operating divisions for the same periods. The appendices of the transfer pricing report contain portions of the statements of operations for each comparable company and the five operating divisions.

245. In order to calculate the net-of-royalty operating profit for each of the five operating divisions as if it was a stand-alone entity, Grant Thornton had to allocate to each division a portion of Sherwin-Williams' Corporate Division's ("Corporate") sales and expenses. Corporate overhead allocation tables for each operating division are included in the appendices.

246. To allocate Corporate's sales to each operating division, Grant Thornton used the percentage of total net sales ("sales ratio") generated by that operating division. For purposes of calculating the sales ratio, Grant Thornton determined the 1991 total net sales for the five operating divisions to be $3,043,194,444.00. Net sales for the Automotive Division were determined to be $313,651,417.00 in 1991. Net sales for the Consumer Division (that included the operations of the Chemical Coatings Division) were determined to be $932,936,228.00 in 1991. Net sales for the Specialty Division were determined to be $251,731,384.00 in 1991. Net sales for the Paint Stores Division (that included the operations of the International [Domestic] and the Canadian Paint Stores divisions) were determined to be $1,503,000,069.00 in 1991. Net sales for the Transportation Division were determined to be $41,875,346.00 in 1991. The net sales for each of the operating divisions included inter-divisional sales.

247. To allocate Corporate's cost of sales to each operating division, Grant Thornton used the percentage of total cost of sales ("cost of sales ratio") generated by each operating division. For 1991, Grant Thornton determined the total cost of sales for the five operating divisions to be $2,051,668,923.00 (Automotive Division's cost of sales of $176,909,787.00 plus Consumer Division's cost of sales of $764,481,109.00 plus Specialty Division's cost of sales of $176,782,375.00 plus Paint Stores Division's cost of sales of $897,686,681.00 plus Transportation Division's cost of sales of $35,808,971.00).

248. The sales ratio was used to allocate Corporate's general and administration expenses to each of the operating divisions. Marketing expenses were allocated to each operating division based on Sherwin-Williams' records. Grant Thornton also had to allocate the depreciation

expense because most of the assets of Sherwin-Williams are located in the Corporate Division. Grant Thornton used the sales ratio to allocate depreciation to each operating division.

249. To establish comparability with operating profits for 1989 and 1990, Grant Thornton computed Sherwin-Williams' net-of-royalty operating profit for each operating division by applying the same royalty rate to sales percentage in those years as each of Sherwin-Williams' operating divisions paid in 1991. The 1991 royalty rate to sales percentage for each operating division was determined to be the following: Automotive Division 3.56% (SWIMC); Consumer Division 0.50% (SWIMC); Specialty Division a total of 1.93% (consisting of 0.09% for SWIMC and 1.84% for DIMC); Paint Stores Division a total of 1.77% (consisting of 1.68% for SWIMC and 0.09% for DIMC); and Transportation Division 0.00%.

250. Since the license agreements went into effect in February 1991, this approach only included the royalties that Sherwin-Williams paid on February to December sales. To adjust the royalty rate in those years to what it would be on a full-year basis, assuming that sales are spread evenly throughout the year, it is necessary to increase each royalty rate by 9.09% (12/11-1 = 9.09%). The annualized royalty rates by division would be: Automotive Division 3.88% (an increase of 0.32%); Consumer Division 0.55% (an increase of 0.05%); Specialty Division 2.10% (an increase of 0.17%) and Paint Stores Division 1.93% (an increase of 0.16%).

251. To determine the profitability of the comparable companies, Grant Thornton calculated the fully-loaded cost plus ratio and the operating margins generated by the comparable companies. The PLI used for the manufacturing and transportation comparables was the fully-loaded cost plus ratio. The fully-loaded cost plus ratio is the ratio of operating profit to total costs (cost of goods sold plus operating expenses). In the transfer pricing report, Grant Thornton

noted that the fully-loaded cost plus ratio is not specifically mentioned in the IRC § 482 regulations, but is frequently used by practitioners as a reliable gauge to evaluate the routine profit levels of manufacturing and service companies. For the Paint Stores Division's comparables, Grant Thornton used the ratio of operating profit to sales.

252. Grant Thornton used the interquartile range to increase the reliability of the profitability analysis.[15] Operating profits falling within the interquartile range are deemed to be at arm's length (Treas Reg § 1.482-1[e][2][iii][B]). In recognition of the fact that the manufacturing and distribution companies identified did not conduct their business operations in exactly the same manner as the five operating divisions, Grant Thornton made adjustments for terms of sale (i.e., accounts receivable) and purchase (i.e., accounts payable) and inventory-holding (i.e., inventory) levels. A summary of the comparable financial results that Grant Thornton reached for each of the operating divisions, on a post-royalty income basis, relative to the comparable companies follows.

253. The Automotive Division was determined to have generated three-year average fully-loaded cost plus markups of 12.28%. On a three-year average basis, the Automotive Division generated profits that fell within the three-year average interquartile range for comparable manufacturing companies, that generated adjusted fully-loaded cost plus markups between 7.15% and 14.05%. For 1991, the Automotive Division's fully-loaded cost plus markup was determined to be 11.17%. That level of profit fell within the 1991 interquartile range for

[15] The interquartile range is defined to encompass results between the 25th percentile and the 75th percentile of the observations derived from uncontrolled comparables (Treas Reg § 1.482-1[e][2][iii][B]).

comparable companies that generated adjusted fully-loaded cost plus markups between 5.70% and 12.19%.

254. The Consumer Division was determined to have generated three-year average fully-loaded cost plus markups of 5.36%. On a three-year average basis, the Consumer Division generated profits that fell within the three-year interquartile range for comparable manufacturing companies that generated adjusted fully-loaded cost plus markups between 3.70% and 9.17%. For 1991, the Consumer Division's fully-loaded cost plus markup was determined to be 4.38%. That level of profit fell within the 1991 interquartile range for comparable companies that generated adjusted fully-loaded cost plus markups between 2.29% and 8.66%.

255. The Specialty Division was determined to have generated three-year average fully-loaded cost plus markups of 7.31%. On a three-year average basis, the Specialty Division generated profits that fell within the three-year interquartile range for comparable manufacturing companies that generated adjusted fully-loaded cost plus markups between 4.80% and 9.07%. For 1991, the Specialty Division's fully-loaded cost plus markup was determined to be 7.92%. That level of profit fell within the 1991 interquartile range for comparable companies that generated adjusted fully-loaded cost plus markups between 2.92% and 13.19%.

256. The Paint Stores Division comparability analysis was done in two steps. First, Grant Thornton used the adjusted operating profits to sales ratio to calculate the profitability of the comparable wholesale distribution companies and the comparable retail distribution companies on a separate basis. Then, the results of the wholesale and retail distribution company data sets were combined, with an 80% weight given to the wholesale data set and 20% weight given to the retail data set.

257. The Paint Stores Division was determined to have generated three-year average operating profit margins of 1.67%. On a three-year average basis, the Paint Store generated operating margins that fell within the three-year interquartile range for comparable wholesale distribution companies that generated operating margins between 0.07% and 2.81%. For 1991, the Paint Stores Division operating margin was determined to be 0.56%. That operating margin fell within the 1991 interquartile range for comparable wholesale distribution companies that generated operating margins between -1.36% and 1.08%.

The Paint Stores Division's three-year average operating margins of 1.67% did not fall within the three-year interquartile range for comparable retail distribution companies that generated operating margins between 3.15% and 4.68%. The Paint Stores Division's 1991 operating margin of 0.56% did not fall within the 1991 interquartile range for comparable retail distribution companies that generated operating margins between 3.04% and 4.54%.

The weighted combined set results in a three-year average interquartile range of 0.69% and 3.18% for the comparable companies. The Paint Stores Division's average three-year operating margin of 1.67% exceeded the median result (1.66%) of the comparable companies and fell within the three-year average interquartile range of the distribution companies. The 1991 interquartile range of the weighted combined set of comparable distribution companies was determined to be between -0.47% and 1.78%. The Paint Stores Division's operating margin of 0.56% for 1991 exceeded the median result (0.02%) of the comparable companies and fell within the 1991 interquartile range developed from the combined weighted set.

258. Although the Transportation Division does not directly sell products and therefore does not pay a royalty, Grant Thornton performed a profitability analysis because that division is

an integral operating unit of Sherwin-Williams and charges the other operating divisions for its transportation services. Grant Thornton determined that the Transportation Division generated three-year average fully-loaded cost plus markups of 9.09%, which was slightly higher than the 8.81% upper quartile exhibited by the comparable transportation companies. During 1991, the Transportation Division's fully-loaded cost plus markup of 8.55% also was above the 0.51% and 7.48% interquartile range of the comparable companies. According to Grant Thornton that indicates that the Transportation Division earned somewhat higher profits than what other transportation companies generated in that year. Although the Transportation Division's profitability was slightly higher than that exhibited by the upper quartile of the sample, its operating results fell within the range of -15.7% and 24.7% generated by all the comparable companies, and therefore was considered arm's length (Treas Reg § 1.482-1[e][2][iii][A]).

259. Mr. Hasenwinkle's analysis reached the conclusion that, on an overall basis, Sherwin-Williams was generating an arm's length level of profit after payment of the royalties. He therefore concluded that the royalty rates paid by Sherwin-Williams' operating divisions were at arm's length.

Analysis of Interest Rate

260. An analysis was performed to determine whether the terms of the loan agreement entered into by SWIMC and Sherwin-Williams were at arm's length. In determining whether SWIMC's loan to Sherwin-Williams was at an arm's length rate of interest, the initial inquiry is whether the loan constitutes a bona fide debt under Treasury Regulation § 1.482-2. Loan characteristics (e.g., term, interest rate, security) are then analyzed to determine whether the interest charged was at arm's length rate.

Mr. Hasenwinkle first determined that SWIMC's loan was bona fide debt. He then concluded, based upon a comparable financing arrangement that Sherwin-Williams had with National City Bank that bore the identical interest rate, that the interest rate charged by SWIMC was at arm's length.

Analysis of Charges for Legal Services

261. An analysis was performed to determine whether the prices Sherwin-Williams charged SWIMC and DIMC for the trademark legal services it rendered for them were at arm's length.

Treasury Regulation § 1.482-2 requires that services must provide a benefit to the recipient. Mr. Hasenwinkle concluded that the requirement was met here since SWIMC and DIMC would have had to hire an intellectual property lawyer to render the necessary services if Sherwin-Williams had not been retained. Mr. Hasenwinkle determined that the rates Sherwin-Williams charged SWIMC and DIMC for the trademark and licensing legal services it rendered fell within the range established by AIPLA of rates charged for the performance of trademark and licensing legal services in the Cleveland/Akron geographical area. Mr. Hasenwinkle determined that the prices charged by Sherwin-Williams were therefore arm's length rates.

262. Mr. Hasenwinkle concluded, based upon his analysis, that each of the intercompany transactions - - the license of the Marks by SWIMC and DIMC to Sherwin-Williams, the loan made by SWIMC to Sherwin-Williams, and the provision of legal services by Sherwin-Williams to SWIMC and DIMC - - clearly passed IRC § 482 muster. Mr. Hasenwinkle therefore concluded that all transactions between Sherwin-Williams and SWIMC and Sherwin-Williams and DIMC were conducted at arm's length.

263. At the hearing, petitioner submitted into evidence two reports prepared by Richard W. Genetelli, a Certified Public Accountant and the founder and principal owner of the Genetelli Consulting Group, which specializes in state and local tax matters. Mr. Genetelli testified at the hearing concerning his findings in those two reports. Mr. Genetelli was accepted as an expert in state and local tax and accounting matters related to this case.

Separate Accounting Report

264. Mr. Genetelli prepared a report evaluating the appropriateness of the Division's proposal to force Sherwin-Williams to file on a combined basis with SWIMC and DIMC (the "Genetelli Report"). The report was prepared after discussions with Sherwin-Williams personnel and after reviewing Sherwin-Williams' Federal and New York State tax returns, annual reports, Forms 10-K and other financial and other internal documentation.

265. The report concluded that the combined reporting should not be required because "the income and activities of The Sherwin-Williams Company are more accurately reflected in New York State on a separate company basis." Mr. Genetelli performed an analysis of the net income generated by Sherwin-Williams in New York State based on a separate accounting concept.

266. In preparing his separate accounting report, Mr. Genetelli found that, in 1991, Sherwin-Williams had 64 paint stores and two automotive branches in New York State. With respect to the paint stores, Mr. Genetelli found that approximately 80 percent of the revenue generated by the paint stores was attributable to sales to wholesalers/contractors. He found that the Consumer Brands, Specialty, Chemical Coatings and International divisions solicited sales in

New York State in 1991. He also determined that Sherwin-Williams' Corporate and Real Estate divisions provided intercompany services in New York State in 1991.

267. Since Sherwin-Williams keeps its books on a divisional basis, not a state-by-state basis, he determined the appropriate amounts of income and expense that should be attributable to New York State for 1991 for each of the divisions conducting activity in New York State. All items of income were based on actual figures. To the extent possible, Mr. Genetelli attributed items of expense to New York State based on actual figures. Where actual figures were not available, Mr. Genetelli used methods described below to attribute expense items to New York State.

268. For the paint stores, Mr. Genetelli allocated the national advertising expense based on sales of the various geographic operating divisions.

269. The Genetelli report imposes internal interest charges ("notional interest") on accounts receivable, other receivables, and on inventory to the paint stores. Mr. Genetelli used an internal interest rate of 12%, the rate personnel at Sherwin-Williams told him was used. During his testimony, Mr. Ault confirmed that the Corporate Division uses an internal interest rate of 12% in its charges to the various divisions for working capital and fixed assets.

270. In his report, Mr. Genetelli charged the New York paint stores with $1,445,979.00 in net internal interest, the impact of which is to convert the net income of $794,383.00 for the New York paint stores to a net loss of ($661,596.00).

271. In his report, Mr. Genetelli allocated the Corporate Overhead Expense to each of the New York paint stores based on a proportion of the New York paint stores sales to the total Paint Stores Division's sales. He did not allocate any Corporate overhead income to New York State.

272. Based on the separate accounting that he performed of Sherwin-Williams, Mr. Genetelli determined that Sherwin-Williams had $1,008,379.00 of entire net income attributable to New York State. Using combined reporting, the Division asserted that Sherwin-Williams' entire net income apportioned to New York State was $5,567,127.00, or 550 percent of the amount determined by using separate accounting.

Arm's Length Analysis

273. Mr. Genetelli also concluded in a separate report that all transactions between Sherwin-Williams and SWIMC and all transactions between Sherwin-Williams and DIMC were at arm's length. Specifically, the royalty and interest rates charged by SWIMC and DIMC to Sherwin-Williams were at arm's length rates, as were the charges by Sherwin-Williams to SWIMC and DIMC for the trademark protection services that Sherwin-Williams performed.

274. The results of Mr. Genetelli's arm's length analysis are memorialized in a report dated November 19, 1998 ("Genetelli arm's length study"). In analyzing the intercompany transactions, Mr. Genetelli used IRC § 482 and the 1994 Treasury regulations. He determined that the best methods for analyzing the royalty rates paid by Sherwin Williams for its use of SWIMC's and DIMC's Marks are the CPM and the PSM.

275. In the application of the CPM, Mr. Genetelli determined whether the royalties paid by Sherwin-Williams to SWIMC and DIMC were arm's length "by comparing Sherwin-Williams' profitability, after deducting royalties, to objective measures of profitability derived from comparable companies engaged in the same line of business as Sherwin-Williams." For purposes of applying the CPM, as well as the PSM, research and development costs were added back to the operating profit figures of Sherwin-Williams and those of the comparables. This is

because research and development expenditures may be capitalized and the benefit of such expenditures is derived over future years.

276. In his arm's length study, Mr. Genetelli states that the PSM determines the appropriate royalty by dividing the profits between Sherwin-Williams and SWIMC and DIMC. In his study, Mr. Genetelli, for purposes of the PSM, applied the widely recognized economic principle that the royalty paid to licensors is generally between 25% and 33% of the profit attributable to the employment of the subject intangibles.

277. Mr. Genetelli determined single composite royalty rates of 2.82 % and 3.51% representing royalties paid to SWIMC and DIMC, respectively. These royalty rates were computed by dividing the total royalties paid to SWIMC and DIMC, respectively, by total respective net sales subject to royalties. According to Mr. Genetelli's study, a single composite rate approach reflects the true effective overall royalty rate paid by Sherwin-Williams in 1991 to SWIMC and DIMC. In addition, use of a single royalty rate for Sherwin-Williams is essential to the comparability analysis since the royalty rates for uncontrolled entities would customarily be stated as a single rate.

278. Mr. Genetelli determined that the CUT method was inapplicable because he could not identify any comparable uncontrolled transactions involving substantially similar intangibles for which sufficient relevant data was available.

279. The Genetelli arm's length study determined that Sherwin-Williams was the appropriate tested party. The selection of the comparables is the next step under the CPM. Various financial data bases, including, among others, Compact Disclosure, Laser Disclosure and Dun & Bradstreet, were searched to locate suitable comparables.

280. The comparables search revealed several suitable comparables specializing in the manufacture and sale of paints, sealants and adhesives, resins and related products. The comparables selected were: (1) Benjamin Moore & Co.; (2) RPM, Inc.; (3) The Valspar Corporation; (4) Lilly Industries, Inc.; and (5) H.B. Fuller Co. Two arm's length ranges were established, one based on the operating profit margins derived from all the comparables and the other based on the rate of return on capital employed (also known as "rate of return on assets").

281. The Genetelli study includes a description of the five comparable companies. All five comparable companies are engaged in manufacturing a diverse range of coatings and distributing them to a broad section of consumers.

282. Two profit level indicators were used in the Genetelli study. They were "operating profits as a percentage of sales" ("operating profits PLI") and rate of return on capital employed"("ROR PLI"). The operating profits PLI measures the relationship between profit to sales, while the ROR PLI is the ratio of operating profit to operating assets. The study states that adjustments for small differences between Sherwin-William and the comparables were, nevertheless, made to accounts receivable and accounts payable levels, as well as inventory. The adjustments were computed using the method prescribed in Treas Reg § 1.482-5(e). The accounts receivable adjustments were a product of the following three factors: (1) the difference between Sherwin-Williams' ratio of accounts receivable to sales and that of each comparable; (2) the average prime rate for the year; and (3) sales of the comparable company in question. The same approach was used to compute the inventory adjustments. Again, the accounts payable adjustments were computed in the same manner, but the results were multiplied by negative one. Mr. Genetelli determined that because these adjustments have been made, the arm's length range

is the entire range of constructive operating profits (Treas Reg § 1.482-1[e][3][iii]). Mr. Genetelli provided the profitability figures for the years 1989 through 1991 for Sherwin-Williams and the comparable companies in accordance with Treas Reg 1.482-5(b)(4).

283. To determine whether the royalty rates paid by Sherwin-Williams to SWIMC and DIMC were arm's length, the Genetelli arm's length study compared Sherwin-Williams' "adjusted operating profit" to the constructive operating profits for each of the comparable companies. The study computed each comparable company's operating profit and then adjusted it by adding back research and development expense and made adjustments in its accounts receivable, payable and inventory accounts. Mr. Genetelli computed the constructive operating profits by applying the profit percentage or ratios derived from the comparable companies' financial data to the financial data of Sherwin-Williams. For example, Benjamin Moore & Co.'s constructive operating profit for 1991 was determined to be $374,394.00. Mr. Genetelli computed that figure by multiplying Sherwin-Williams' sales ($2,541,446.00) for 1991 by Benjamin Moore & Co.'s adjusted operating profits percentage for 1991 of 14.7315%.

284. The Genetelli arm's length study determined that Sherwin-Williams' operating profit of $233,676.00 fell within the range of the constructive operating profits of the comparable companies using both an "operating profits PLI" and a "return on assets" PLI. Specifically Mr. Genetelli's study determined the arm's length range of the 1991 constructive operating profits based on the operating profits PLI to be from $220,118.00 to $374,394.00. The arm's length range of the 1991 constructive operating profits based on the return on operating assets ("ROR") PLI was determined to be $188,444.00 and $416,559.00.

285. In his application of the PSM, Mr. Genetelli applied the 25% to 33% profit split. In the study, Mr. Genetelli explained that this method divides the operating profit of the licensee and licensor, with a 25 percent to 33 percent share of the operating profits going to the licensor in the form of royalty and the remainder being retained by the licensee. According to Mr. Genetelli, "multiplying operating profit figure of a licensee by 25 percent and 33 percent produces a range of royalty rates that would be acceptable to both a licensee and licensor in an arm's length transaction."

286. Mr. Genetelli applied the 25% to 33% range to the adjusted operating profits figures of each of the comparable companies and Sherwin-Williams. Mr. Genetelli calculated Sherwin-Williams' adjusted operating profit by taking the company's unadjusted operating profits plus the royalties paid for 1991, plus research and development expenditures. In the study, Mr. Genetelli explains that the royalties were added back to profits to arrive at the gross figure to be apportioned between the licensor and licensee, in order to determine what portion of the profit represents royalties due to the licensor.

287. Mr. Genetelli determined a range of 1991 royalty rates of 2.17% to 4.86% for the lower and upper ends of the range, respectively for the five comparable companies examined. He determined the range of royalty rates that would result for Sherwin-Williams when the 25% to 33% profit split formula is applied to be 2.75% to 3.63%. The actual royalty rates paid by Sherwin-Williams to SWIMC (2.82%) and DIMC (3.51%) fell within the two arm's length ranges developed by Mr. Genetelli using this profit split approach.

288. The Genetelli study determined that Sherwin-Williams' profitability figures fell within both of the arm's length ranges established under the CPM. It also determined that the

royalty rates fell within the range of arm's length royalty rates created using the PSM. In the study, Mr. Genetelli found the royalty rates paid by Sherwin-Williams to SWIMC and DIMC to be arm's length.

289. As part of the arm's length study, Mr. Genetelli also reviewed the interest rate charged by SWIMC on the loan that it made to Sherwin-Williams to determine if the rate charged was arm's length. He identified a revolving line of credit agreement entered into between National City Bank and Sherwin-Williams, which agreement was outstanding at the same time as SWIMC's loan to Sherwin-Williams. The 5.8125% rates on both the line of credit and the SWIMC loan were identical. Mr. Genetelli concluded that the interest rate SWIMC charged Sherwin-Williams was an arm's length rate.

290. Mr. Genetelli also determined that Sherwin-Williams' charges for services rendered to SWIMC and DIMC under the services agreements were arm's length. Three separate analyses of the rates, i.e., on an hourly basis, on a task basis and on a project basis, were performed in reaching that conclusion.

The Division's Expert Witnesses

291. At the hearing, the Division presented the testimony of Dr. Alan C. Shapiro, and submitted into evidence two reports prepared by Dr. Shapiro. Dr. Shapiro's testimony and reports critiqued the AAA appraisal and the Grant Thornton Transfer Pricing Report and addressed the economic substance of SWIMC and DIMC.

292. Dr. Shapiro has a Ph. D. in economics from Carnegie Mellon University and has taught economics and finance for more than 25 years. He is the Ivadelle and Theodore Johnson Professor of Banking and Finance at the Marshall School of Business at the University of

Southern California. Dr. Shapiro has written five books on the topic of corporate finance. He has testified as an expert in transfer pricing and valuation issues and whether transactions have economic substance. Dr. Shapiro did not prepare a transfer pricing report. He was accepted as an expert in economics, transfer pricing and corporate finance.

293. Based on his background in economics and value based management, Dr. Shapiro testified about the economic substance of Sherwin-Williams' assignment of the Marks to SWIMC and DIMC and its non-exclusive license back of the Marks. He concluded that there was no economic substance underlying the formation of SWIMC and DIMC.

294. It was Dr. Shapiro's opinion that SWIMC and DIMC are unable to add value to the trademarks. He testified that if SWIMC and DIMC were very actively involved in brand management, through the exercise of their rights under the licensing agreements with petitioner (e.g., the right to approve brand extensions, the right to review and approve advertising, the right to engage in quality control), petitioner would be subjecting itself to great risks because SWIMC and DIMC would be engaging in brand management without the necessary information to make intelligent decisions. That is, if SWIMC and DIMC actually made critical brand management decisions, they would destroy value because their personnel do not have the information and experience needed to make those decisions correctly. Therefore, according to Dr. Shapiro, the assignment and license back transaction would have no economic substance because there was no rational expectation that the benefits of the transaction would exceed its costs.

295. Conversely, according to Dr. Shapiro, if SWIMC and DIMC were only nominally involved in brand management, the assignment and license back transaction would merely be

creating an unnecessary level of corporate bureaucracy that does not add any value to the overall enterprise, i.e., there would be no rational expectation of profit from the transaction.

296. Dr. Shapiro admitted that SWIMC and DIMC were involved in some aspects of brand management such as quality control, trademark renewal decisions and third-party licensing.

297. Dr. Shapiro testified that from an economic perspective, it would be irrational to put someone in charge of the trademarks who is outside of petitioner's organization and who has no knowledge of its brands, customer requirements and corporate capabilities.

298. According to Dr. Shapiro, the assignment and license back transaction would not have any economic substance even if SWIMC and DIMC consulted with petitioner's brand managers as to how the trademarks should be used. It was his opinion that the least likely alternative that one would select would be to take somebody who is not part of the internal organization, who has no knowledge of the brands, the products, customer requirements, or corporate capabilities and place that person in another location with responsibility to make decisions related to brand management.

299. According to Dr. Shapiro, it would not make sense from an economic perspective for a successful company that adds value to the trademarks to sell its trademarks to a third party and remain in the core business. Economic theory would predict that a company would not sell its trademarks to a third party while remaining in business except under extreme circumstances such as dire economic distress. An unsuccessful company, one that does not have the necessary intangibles to exploit a trademark might assign the mark. A successful company, by definition, has a host of other intangible assets in its core business. The excess returns earned on branded

products are directly related to the amount of other intangible assets the company is employing. Hence, it would expect to earn higher returns by using the marks itself as opposed to selling them off.

300. Dr. Shapiro opined that the creation of SWIMC and DIMC and the assignment of the trademarks to those subsidiaries adds significant complexity to the accountability process regarding use and management of the marks.

301. In Dr. Shapiro's view, the assignment of a trademark to a subsidiary that is managed by an outsider who does not understand the brand value proposition underlying the trademark is not a rational way to engage in third-party licensing. Dr. Shapiro suggested some other ways for petitioner to enhance the amount of third-party licensing revenue, including giving SWIMC and DIMC the right to license the trademarks to third parties.

302. It was Dr. Shapiro's opinion that having SWIMC and DIMC do quality control is either dangerous or redundant.

303. According to Dr. Shapiro, it does not make sense from an economic perspective for petitioner to create SWIMC and DIMC for the purpose of engaging in securitization until the specific need arises. It was his opinion that petitioner could segregate the cash flow pertaining to the trademarks by simpler means than using SWIMC and DIMC as vehicles for securitization.

304. Dr. Shapiro testified that selling off assets that are intimately linked to the operation of petitioner's core business in order to forestall a hostile takeover would go beyond the "crown jewels" defense. According to Dr. Shapiro, the sale of such assets would make no economic sense.

305. Petitioner had, prior to the formation of SWIMC and DIMC, adopted a "poison pill"

anti-takeover defense. According to Dr. Shapiro, it does not necessarily make economic sense for the management of a corporation to maximize the number of anti-takeover defenses.

306. Dr. Shapiro testified that, assuming the conveyance of the trademarks to a third party is an effective anti-takeover defense, a rapid conveyance of the trademarks is not critical to the success of the defense. The transfer of trademarks can be effectuated by a simple sales contract; it is not necessary to record the transfer of the trademarks with the U.S. Patent and Trademark Office in order to effectuate a transfer of the trademarks.

307. He also testified that transferring assets from petitioner to SWIMC and DIMC does not prevent petitioner's creditors from seizing those assets because its stock in the subsidiaries is an asset owned by petitioner and, thus, could be seized by petitioner's creditors.

308. Dr. Shapiro acknowledged that corporations have the right to transfer their assets into separate companies without geographic restriction.

Dr. Shapiro's Critique of the AAA Report

309. In his report, Dr. Shapiro concludes that AAA's conclusions were inconsistent with economic reality, a condition stemming from major methodological problems with the analysis.

310. According to Dr. Shapiro, AAA improperly applied the 25% to 33⅓% profit split. If the profit split is applied in the manner proposed in the AAA report, petitioner would be unable to earn its cost of capital on the operating, i.e., tangible, assets necessary to produce the branded products. For example, a 33% split applied to operating profit would have left Sherwin - Williams earning over two percentage points less than its cost of capital.

311. Dr. Shapiro testified that it does not make sense from an economic perspective to apply the profit split percentage to total net profit. According to Dr. Shapiro, the 25% to 33%

rule of thumb should be applied to residual profit. Dr. Shapiro's report applied the 25% to 33% profit split rule of thumb to Sherwin-Williams' residual operating profits (by calculating its return on assets and subtracting its weighted average cost of capital) and found that, so calculated, the royalty rates petitioner would have paid would be in the range of between .41% and .54% of net sales.

312. According to Dr. Shapiro, AAA overestimated the appropriate cost of capital to apply to the projected royalty cash flows. As a result of this overestimation, AAA underestimated the value of the trademarks assigned to SWIMC and DIMC. Dr. Shapiro found that the beta estimated by Value Line for petitioner in 1991 was 1.20. He determined that a conservative estimate of beta for petitioner's royalty payments would be one-half of petitioner's overall beta (0.6) and determined a cost of equity capital for the royalty income equal to 12.34%. Dr. Shapiro then used a weighted average cost of capital of 12% and computed the fair market value of the trademarks to be $658,300,000.00, almost double the value determined by AAA.

313. Dr. Shapiro testified that it did not make any sense from an economic perspective that petitioner's trademarks accounted for approximately 76% of petitioner's total intangible value. He also testified that the other intangible assets of petitioner such as multiple distribution channels, ability to adapt to a changing marketplace, were worth more than 25% of petitioner's total intangibles. However, he did not determine the value of the other intangibles he identified.

Dr. Shapiro's Critique of the Grant Thornton Transfer Pricing Report

314. Dr. Shapiro agreed that the CPM is a valid method under IRC § 482 and that Grant Thornton was correct in using it.

315. Dr. Shapiro testified that there was a flaw in Grant Thornton's search methodology, specifically, the exclusion of companies with substantial intangibles. He testified that the effect of excluding companies with substantial intangibles is to push the interquartile range in a downward direction because companies with substantial intangibles are likely to be the most profitable companies in an industry because they are earning returns on those intangibles. The intangibles that contribute to a company's success include a good distribution system, technological assets, marketing skills, and organizational capabilities that allow its workforce to work effectively together to design, develop, produce, distribute and market a branded product.

316. Dr. Shapiro testified that market level is important in the selection of comparables. The economics of making retail sales and OEM sales are completely different. The vastly larger volume of a sale to an OEM will cause a seller to accept a smaller margin in exchange for achieving a higher asset turnover.

317. Dr. Shapiro testified that sales volume and geographic scope should be taken into account when comparables are chosen. He testified that regional companies would not be as comparable to petitioner as national companies would because regional companies would be subject to the region's economic cycle that might be different from the national economic cycle.

318. Dr. Shapiro pointed out that in 1991 the Northeast suffered a recession that was more severe than the national economy's recession. According to Dr. Shapiro, the effect of using regional companies doing business in the Northeast in 1991 would bias the interquartile range downwards.

***Dr. Shapiro's Critique of the Genetelli Separate Accounting Report*.**

319. Dr. Shapiro reviewed the separate accounting report. He testified that he was unable to verify the numbers in that report, as he was unable to tie the numbers in the separate accounting report back to petitioner's audited financial statements.

320. Dr. Shapiro noted that the Genetelli separate accounting report imputes notional internal interest to petitioner's operating divisions even though there is no such interest expense on petitioner's Federal income tax return. He testified that the imputation of notional internal interest causes income to be severely understated in the Genetelli separate accounting report.

Dr. Shapiro's Critique of the Genetelli Arm's Length Analysis

321. Dr. Shapiro testified that it was an error for the Genetelli pricing report to add back the royalties petitioner paid to SWIMC and DIMC in computing petitioner's operating margins for purposes of the report's profit split test because the royalties paid by the operating divisions to SWIMC and DIMC simply wash out on a consolidated basis. According to Dr. Shapiro, by adding back the divisions' royalty expense, the Genetelli pricing report double-counted that expense, causing the report to derive a higher royalty rate than it would have otherwise.

322. Dr. Shapiro testified that it was also erroneous for the Genetelli pricing report to add back petitioner's research and development expense without adding any amortized expense for research done by petitioner in the past that is still benefitting it today.

Bromberg Testimony

323. At the hearing, the Division presented of the testimony of Lee Carl Bromberg, a trademark attorney, and submitted into evidence a report prepared by Mr. Bromberg.

324. Mr. Bromberg is a partner with the Massachusetts law firm of Bromberg & Sunstein LLP. Mr. Bromberg's practice concentrates on complex commercial cases with special emphasis on patent, trademark, copyright, trade secret, unfair competition and related cases in high technology areas. Mr. Bromberg was accepted as an expert in trademark law and practice.

325. Mr. Bromberg's testimony and report concluded that the transfer and license-back of the trademarks does not result in any advantages as a matter of trademark law, practice and strategy. Mr. Bromberg further concluded that the transfer and license-back entails several significant disadvantages with respect to the trademarks, and a serious risk to their invalidation.

326. Mr. Bromberg, in his report and testimony, stated that, in his opinion, Sherwin-Williams is the entity that generates all the goodwill for the Marks after assignment to SWIMC and DIMC.

327. Mr. Bromberg testified that if SWIMC and DIMC are independent trademark managers there is a risk of a naked assignment and naked license back. He testified that the assignment of the trademarks to SWIMC and DIMC could be determined to be a mere transfer of paper title without goodwill and thus an assignment in gross that would render the trademarks invalid.

328. Mr. Bromberg acknowledged that SWIMC and DIMC are the legal owners of the trademarks. He further acknowledged that he knew of no instances where there have been holdings that the Sherwin-Williams assignment and license back of trademarks resulted in naked licensing.

329. It was Mr. Bromberg's opinion that there were simpler and more efficient ways to achieve the benefits outlined by Sherwin-Williams in its business plan.

330. Mr. Bromberg testified that the 2.8% average royalty rate that Sherwin-Williams was charged for its use of the Marks under the License Agreements with SWIMC and DIMC was "in the ballpark of transactions" in which he has been involved. Mr. Bromberg testified that he had first hand experience with a company that owned trademarks, but did not have any ongoing business.

Conduct at the hearing

331. On June 29, 1999, at the beginning of the hearing, the Division requested that the Administrative Law Judge exclude all fact witnesses from the hearing room. The request was granted and all fact witnesses for both sides left the hearing room.

332. On June 30, 1999, petitioner presented the testimony of Ms. Starr, the Certified Public Accountant, who was responsible for the external audits conducted by Wade & Santora and who also performed quality control audits for SWIMC and DIMC.

333. Mr. Pragel, one of the Division's fact witnesses, was present during Ms. Starr's testimony.

334. The Division did not request permission from the Administrative Law Judge for Mr. Pragel's presence in the hearing room during Ms. Starr's testimony. Mr. Pragel testified that "[s]omebody came in and told me to get down there and get in the room".

335. Mr. Pragel, along with other Division fact witnesses, were sitting in a conference room at the Division of Tax Appeals Troy offices during the days that the hearing continued in Troy, specifically July 15, 16, and 26 through 30, 1999. While sitting in that conference room, he overheard snippets of the conversations that the Division's attorneys conducted among themselves, but was unable to piece it all together.

336. On July 15, 1999, Mr. Pragel was also present during Mr. Panno's testimony regarding his efforts on behalf of petitioner to respond to the subpoena duces tecum issued to it for the production of certain documents.

337. In preparation for his testimony, Mr. Pragel reviewed, among other things, documents that were part of the record. Specifically he reviewed SWIMC's and DIMC's custody account records and the batch reports of bank activity. Mr. Pragel testified on September 8, 1999.

Subpoenas

338. By request dated May 21, 1999 and received by the Division of Tax Appeals on May 26, 1999, the Division requested the issuance of a subpoena duces tecum for certain documents in the possession of petitioner. The request was granted and on June 3, 1999, a subpoena duces tecum was issued to petitioner for the production of certain documents.

339. The Division served its subpoena upon Sherwin-Williams on June 10, 1999, 19 days before the hearing was to commence. The subpoena was 3 pages long and contained 23 paragraphs.

340. By a motion dated and received by the Division of Tax Appeals on June 17, 1999, the petitioner sought withdrawal of the subpoena or, in the alternative the modification of the subpoena. By order dated June 28, 1999, the subpoena was modified.

341. Mr. John Panno, Tax Counsel for petitioner, was responsible for responding to the Division's subpoena.

342. In light of the short period of time to comply with the Division's subpoena as well as the large volume of material requested, Mr. Panno focused his search. He searched files in

Sherwin-Williams' legal and tax departments comprising at least 15 file folders, obtained information from the Sherwin-Williams accounting department, and had discussions with Dr. Puglisi, Mr. McDonald and Mr. Ault's assistant.

343. Mr. Panno did not speak with any members of petitioner's board of directors in his attempt to comply with the Division's subpoena.

344. Mr. Panno never spoke with petitioner's Chief Financial Officer ("CFO") or Chief Executive Officer ("CEO") in his attempts to comply with the Division's subpoena; nor did he request that anyone review either the CFO's or CEO's files in order to find out if they might contain something that was needed in order to comply with the Division's subpoena.

345. The Division's Subpoena Item Number 2 requested: "All inter-company agreements between or among SWIMC, Inc. ("SWIMC"), DIMC, Inc. ("DIMC") and other entities in The Sherwin-Williams Company's federal consolidated filing group, including The Sherwin-Williams Company. Any loan agreements, or promissory notes by or to SWIMC or DIMC."

346. In response to the Division's subpoena Item Number 2, petitioner supplied the Division with the SWIMC/Sherwin-Williams License Agreement. Petitioner also supplied the Division with an Amendment No. 3 to the SWIMC/Sherwin-Williams License Agreement. However, petitioner never supplied the Division with either: (i) the Amendment No. 1 to the SWIMC/Sherwin-Williams License Agreement, or (ii) Amendment No. 2 to the SWIMC/Sherwin-Williams License Agreement.

347. The Division's subpoena Item Number 3 requested: "The communications, including reports, between third-party advisers and any entities within The Sherwin-Williams Company's federal consolidated filing group relating to the creation or capitalization of a corporation to hold

the subject trademarks or trade names." Petitioner provided the Division with nothing in response to subpoena Item Number 3.

348. Mr. Panno never attempted to reconcile his claim that he could not find anything covered by the Division's subpoena Item Number 3 with the January 18, 1991 Business Plan, a document he did locate, that makes reference to a number of third-party advisors, including the law firm of Duane Morris and American Appraisal Associates.

349. The Division's subpoena Item Number 4 requested:

> The documents referring or relating to the decision of The Sherwin-Williams Company, its directors, officers, employees, agents and any entity in which The Sherwin-Williams Company holds an ownership interest, directly or indirectly, in excess of 50% ("the petitioner"): (a) to transfer trademarks or trade names to separate subsidiaries and/or to license those trademarks back; and (b) to incorporate the subsidiaries to whom the trademarks were to be assigned in Delaware. Any document relied upon by the board of directors of The Sherwin-Williams Company in approving the transfer of the subject trademarks and trade names.

350. In response to the Division's subpoena Item Number 4, petitioner provided a copy of the January 23, 1991 meeting of Sherwin-Williams Board of Directors and the January 18, 1991 Business Plan.

351. In a letter dated August 24, 1999 to the Administrative Law Judge, the Division made requests for additional documentation. None of the documents relating to the creation of SWIMC and DIMC that were identified in the testimony of Messrs. Ault and Ivy were produced.

352. The Division's subpoena Item Number 5 requests:

> All documents, including all backup materials, relating to (a) the setting of the royalty rate for each of the subject trademarks or trade names or for categories thereof or (b) the analysis of whether the royalty rates for the subject trademarks were arms-length. (The American Appraisal Associates appraisal report need not be produced, but all communications between the petitioner and American

> Appraisal Associates in regard or relating to the preparation of that report must be produced, along with any backup material used, reviewed, or prepared by American Appraisal Associates in preparing the report.)

353. In response to the Division's subpoena Item Number 5, petitioner supplied the Division with a letter dated December 7, 1990 from petitioner by Robert A. McDonald, Senior Corporate Counsel, Patent and Trademarks to Ms. Benkler of American Appraisal Associates (the "December 7 1etter"). That letter expressly refers to several abstracts of foreign license agreements (the "Abstracts"), which were never provided to the Division. Mr. Panno's response to not providing the Abstracts was that he did not know why they were not sent, and he testified that he "must not have read it [the Division's subpoena] closely enough". Although petitioner's counsel stated at the hearing that petitioner would look for the document, the Abstracts were never provided to the Division; nor were the actual foreign license agreements themselves ever provided to the Division.

354. In response to the Division's subpoena Item Number 5, the petitioner also supplied the Division with a letter, dated February 4, 1991, from American Appraisal Associates to Mr. Cummings (the "AAA" letter). The AAA letter refers to an attached draft report prepared by AAA that values petitioner's trademarks. Petitioner never supplied the Division with a copy of the AAA draft report, nor was any explanation for its possible whereabouts ever provided.

355. The Division's subpoena Item Number 21 requested: "The document retention manual or other document setting forth the document retention policy of the petitioner." In response to the Division's subpoena Item Number 21, petitioner supplied the Division with its Tax Department's document retention policies. Petitioner admitted that there may be other document retention policies for other divisions which were not supplied.

356. Mr. Panno relied solely on his review of the 15 Tax Department files in order to comply with the following Division subpoena items: Item Number2; Item Number 3; Item Number 4; Item Number 8; Item Number 9; and Item Number 21. To comply with some of the item requests contained in the subpoena, Mr. Panno reviewed a file folder maintained within Sherwin-Williams' legal department.

357. By a request dated June 4, 1999, and received by the Division of Tax Appeals on the same date via facsimile, petitioner requested the issuance of a subpoena duces tecum for certain documents in the possession of the Division. The request was granted and on June 9, 1999, a subpoena duces tecum was issued to the Division for the production of certain documents.

358. The records that were to be produced pursuant to the subpoena duces tecum were as follows:

> 1. The Division of Taxation's (the "Division") audit file, including all communications, correspondence, documents, tax returns, memoranda, tape recording, reports, notes, transcripts, work papers, and any other materials, concerning the audit of The Sherwin-Williams Company for the period January 1, 1987 through December 31, 1991.
>
> 2. All documents and/or communications outlining, discussing, evaluating, or otherwise referring to the Division's assertion that The Sherwin-Williams Company was required to file a combined corporation franchise tax report with DIMC, Inc. ("DIMC") and/or SWIMC, Inc. ("SWIMC").
>
> 3. All documents and/or communications passing between or among the Division's representative's or personnel, which refer to relate to, discuss and/or otherwise concern the audit of The Sherwin-Williams Company for the period January 1, 1987 through December 31, 1991 and/or the Notice of Deficiency issued by the Division in this matter.

359. Petitioner served its subpoena upon the Division. The Division's Office of Counsel sent requests to the Buffalo District Office and the Albany Field Audit Management ("FAM")

Section of the Audit Division for the retrieval of documents that would be responsive to petitioner's subpoena.

360. Mr. Bonnim Tanzman, an auditor in FAM, was in charge of the retrieval of documents from that office. He instructed Mr. Richard Mayer, Ms. Dawn D'Arcangelo, Ms. Alyce Fahrenkopf, Mr. Terry O'Neil and Mr. John Verde to review their files, including their saved e-mails for any documents that would be responsive to the subpoena.

361. Mr. Tanzman reviewed and copied documents pertaining to Sherwin-Williams from FAM's file drawer that contained all the combined reporting cases. He also reviewed and copied all of his saved e-mails, and the attachments to those e-mails.

362. Mr. Mayer supplied him with documents. Ms. D'Arcangelo gave him an e-mail and the other three informed him that they had no documents.

363. Mr. Tanzman collected the documents and brought them to Mr. Robert Maslyn, an attorney in the Division's Office of Counsel. A transmittal list of the documents was not prepared by Mr. Tanzman.

364. Mr. Pragel was the Division employee designated to be responsible for the Buffalo District Office's response to petitioner's subpoena. Mr. Pragel searched all the files related to petitioner and supplied them to the Office of Counsel.

365. The Buffalo District Office sent two boxes of materials to Mr. Della Porta who then handed the sealed boxes over to Mr. Maslyn.

366. Mr. Maslyn was assigned responsibility to review the materials received from the Buffalo District Office and FAM; sort out those materials that were covered by the attorney-

client privilege; retain those documents and segregate out the materials that would be turned over pursuant to the subpoena.

367. Mr. Maslyn reviewed all documents, including those sent in triplicate by the Buffalo District Office and placed a "post-it" or a portion of a "post-it" on the materials covered by the attorney-client privilege. He did not place "post-its" on the non-privileged materials. The privileged materials were not physically separated from the other materials. Rather, both the privileged materials and the non-privileged materials were in piles on his desk.

368. On the Friday afternoon prior to the first day of the hearing (June 29, 1999), Mr. Maslyn approached Mr. Clifford Peterson, one of the attorneys in the Office of Counsel working on the instant matter. Mr. Maslyn told Mr. Peterson that the privileged material had been flagged with "post-its" and handed all the documents, privileged and non-privileged, over to him.

369. Neither Mr. Maslyn nor Mr. Peterson prepared a privilege log; nor was a list of the non-privileged documents that were to be turned over in response to petitioner's subpoena prepared.

370. At the hearing on June 29, 1999, Mr. Connolly instructed Mr. Peterson to get the materials in response to petitioner's subpoena and place them on the table so that Mr. Connolly could turn them over to petitioner's representative.

371. Prior to removing the materials from the box labelled "response to subpoena," Mr. Peterson removed the "post-its." He then placed the pile on the table in front of Mr. Connolly. He did not inform Mr. Connolly that the materials included privileged documents.

372. At that point, documents were exchanged by both parties in response to the respective subpoenas. The documents supplied by petitioner in response to the Division's

subpoena were sorted by item number. However, the Division's documents responsive to petitioner's subpoena were not sorted. Petitioner immediately returned the documents to Mr. Connolly in order that the auditors, including Mr. Tanzman could sort them by item number. The sorted documents were turned over to petitioner's representative on June 30, 1999.

373. At the hearing on July 15, 1999, petitioner identified four e-mails whose attachments were not included in the Division's response to petitioner's subpoena. Those e-mails were identified as: first, one from Mr. Porempski to Mr. Peterson, second, an e-mail from Mr. Verde with a reply from Mr. Tanzman, third, an e-mail from Mr. Joseph Bremer to Mr. Tanzman, and fourth, an e-mail from Mr. Porempski to Mr. Tanzman. The Division agreed to search its records and supply copies of the four attachments to those e-mails.

374. On July 16, 1999, petitioner requested that the Division supply it with copies of seven attachments to e-mails that had been supplied from the Buffalo District Office in response to petitioner's subpoena. The e-mails, without attachments, were entered into evidence as Petitioner's Exhibit "17." Petitioner's representative, Mr. Frankel, stated that whether the attorney-client privilege applied to those attachments was a decision that the Division could make before supplying the copies of the attachments.

375. The Division sent petitioner's representative Mr. Fields a letter on July 22, 1999. Mr. Della Porta enclosed the attachment to the e-mail from Mr. Porempski to Mr. Tanzman dated January 12, 1999. That attachment was a copy of a letter, dated December 23, 1998 from Mr. Porempski to Mr. Frankel. The Division's July 22, 1999 letter stated that although the letter of December 23, 1998 referred to the December 31, 1988 through December 31, 1991 audit period, subsequent correspondence clarified that the letter was intended only to apply to a subsequent

audit period. Mr. Della Porta's letter stated that the attachments to the e-mails from Mr. Verde to Mr. Tanzman dated January 29, 1999 and from Mr. Bremer to Mr. Tanzman dated January 28, 1999 were drafts of letters to petitioner that pertained to the subsequent audit period. The letter also stated that the attachment to the June 8, 1999 e-mail from Mr. Porempski to Mr. Peterson was covered by attorney-client privilege. The letter, dated December 23, 1998 from Mr. Porempski to Mr. Frankel was entered into evidence as the Division's Exhibit "RRR."

376. By letter dated July 22, 1999, Mr. Fields informed the Division that material supplied by it in response to petitioner's subpoena was missing certain items: the auditor's time logs; most of the telephone conversation records and some of the correspondence between the Division and Sherwin-Williams.

377. As a result of Mr. Fields' July 22, 1999 letter, the Division realized that it had failed to provide the audit file in response to petitioner's subpoena. By letter dated July 22, 1999, the Division informed Mr. Fields that it had sent a copy of the audit file to him by overnight mail. The letter also stated that copies of the tax field audit record (which most closely matched the description of auditor's time logs) and the telephone conversation records were being faxed that day to Mr. Fields.

378. On July 15, 1999, Mr. Tanzman testified about the steps he took in searching for documents responsive to petitioner's subpoena. At that time, Mr. Tanzman stated that he had not reviewed any e-mails contained in his sent box.

379. In late July 1999, Mr. Tanzman and Mr. Mayer searched their computer files a second time and copied all information on petitioner contained in their sent files and in-basket files. The results of those searches were given to Mr. Maslyn.

380. In late July 1999, Mr. Maslyn reviewed the additional material that he had received from Messrs. Tanzman and Mayer and physically segregated the attorney-client privileged material from the non-privileged material in piles on his desk. Mr. Maslyn labelled the piles. However, he did not prepare a privilege log.

381. In late July 1999, Mr. Peterson collected the non-privileged documents from Mr. Maslyn's desk and turned them over to Mr. Della Porta during the continued hearing in Troy. There is no evidence in the record that Mr. Della Porta turned any additional documents over to petitioner's representative.

382. At the close of the hearing on July 16, 1999, petitioner undertook to try and locate three additional documents, the May 1, 1991 assignment agreement regarding SWIMC, the October 15, 1991 assignment agreement regarding DIMC and the abstracts of the foreign licenses given to AAA.

383. On July 26, 1999, petitioner gave the Division copies of the May 1, 1991 SWIMC assignment agreement and the October 15, 1991 DIMC assignment agreement as well as two other assignment agreements for SWIMC. Mr. Fields stated that petitioner went back through its files but was unable to locate the abstracts of the foreign license because they no longer exist.

384. The transcript for July 26, 1999 reflects that the Division had responded to all of the inquiries concerning attachments to e-mails. Mr. Fields did not disagree that the Division had responded to his inquiry concerning all of the attachments and stated that he understood "the Division's position on those [attachments]".

385. In a letter, dated August 24, 1999, to the Administrative Law Judge, the Division asserted that petitioner had not complied with the Division's subpoena, as modified by the order of June 28, 1999, specifically with respect to subpoena item numbers 2 and 4.

386. In a letter dated August 31, 1999, petitioner responded to the assertions made in the Division's August 24, 1999 letter. In that letter, Mr. Frankel stated that the record was clear that petitioner had fully and properly complied with the Division's subpoena. The letter also addressed the Division's failure to respond fully to petitioner's subpoena. Mr. Frankel pointed out the Division's failure to supply the audit file and Mr. Tanzman's failure to review all relevant files in his computer in response to petitioner's subpoena. He expressed concern that the additional documents could exist in the files that were not searched. He further stated that the Division had never provided petitioner with any such documents or informed petitioner that no such documents in fact exist. Mr. Frankel's letter also outlined other actions taken by the Division in this matter that he considered to be improper and cast doubt that the Division had fully complied with petitioner's subpoena. Specifically he identified the Division's use of a subsequent audit period to seek documents related to the audit and Notice of Deficiency at issue in the present matter.

387. In support of the assertions in his letter concerning the Division's failure to respond to petitioner's subpoena and its improper conduct, Mr. Frankel enclosed documents marked as exhibits "A" through "K." Those exhibits included, among other things, e-mails exchanged by the Office of Counsel and various members of FAM and the Buffalo District Office.

388. On September 1, 1999, the Division sent a letter to the Administrative Law Judge stating that the Office of Counsel had not been authorized to waive any attorney-client privilege

in its response to petitioner's subpoena. Mr. Della Porta went on to state that it was possible that "through an oversight, material covered by the privilege was conveyed over to Sherwin-Williams counsel." He went on to state that if that had occurred that inadvertent disclosure could not constitute a waiver of privilege. Mr. Della Porta requested that a protective order be issued precluding the use at the hearing of any subpoenaed materials in the hands of opposing counsel that was covered by the attorney-client privilege.

389. At the hearing on September 9, 1999, petitioner submitted into evidence, as its exhibits "35" and "36," some e-mails that it had received from the Division in response to petitioner's subpoena. Exhibit "35" is a single-page copy of two e-mails, an e-mail from Mr. Porempski to Mr. Brian McCann, an attorney with the Office of Counsel, with a copy to Mr. Pragel and the forwarding of that e-mail by Mr. Pragel to Mr. Hanny, another auditor. That exhibit consists of an e-mail communication between an auditor and a member of the Office of Counsel concerning the name and address of a fact witness, Dr. Puglisi. The e-mail advises Mr. McCann that a package will be forthcoming and discusses conversations with other auditors about a subsequent audit period for Sherwin-Williams. Exhibit "36" is a two-page document concerning six e-mails forwarded among and between various employees of the Audit Division, including Mr. Tanzman, and the Office of Counsel. The e-mails discuss the issuance of a subpoena to petitioner and the appropriateness of serving a copy on someone in authority in the Sherwin-Williams hierarchy.

390. On September 10, 1999, the Division recalled Mr. Tanzman as a witness to testify about, among other things, whether he was aware of a "conspiracy within the Department against Sherwin-Williams, to disturb management or to engage in unnecessarily long litigation." During

Mr. Tanzman's cross-examination, he admitted that both he and Mr. Pragel were in the room during Mr. Panno's testimony on July 15, 1999. Petitioner's representative also asked Mr. Tanzman questions concerning his involvement in the subpoena "conspiracy."

391. At the conclusion of the hearing both parties made motions. Petitioner made two motions. The first was a motion to have Mr. Pragel's testimony stricken from the record, and the second was a motion to have a negative inference drawn from the Division's response to petitioner's subpoena. The Division also made two motions. The first was a motion to have material protected by the attorney-client privilege stricken from the record, and the second was a motion to have a negative inference drawn from petitioner's failure to fully comply with the Division's subpoena.

392. Petitioner submitted proposed findings of fact numbered "1" through "213". The Division submitted 642 single-spaced proposed findings of fact. The following proposed findings of fact were not adopted for the reasons given.

(a) Petitioner's proposed finding of fact 22 was modified to more accurately reflect the record.

(b) Petitioner's proposed findings of fact 21, 32, 33, 39, 61, 62, 87, 93, 94, 160, 165, 172, 183, 203, 204, 205, 207, 209, 210, 211, and 213 are argumentative or speculative.

(c) Petitioner's proposed findings of fact 29, 77, 80, 81, 82, 106, 117, 118 and 150 were not relevant to the period in issue.

(d) Petitioner's proposed findings of fact 156 and 157 constituted conclusions of law.

(e) The Division's proposed findings of fact 89, 114, 168, 198, 219, 295, 457, 542, and 609 consist almost entirely of quotations from the transcript.

(f) The Division's proposed findings of fact 31, 42 and 74 were modified to more accurately reflect the record.

(g) The Division's proposed findings of fact 13, 21, 49, 50, 82, 90, 92, 109, 111, 112, 115, 117 - 119, 120, 125, 126, 166, 173, 241 - 243, 291, 508 - 510, 642 are argumentative, excessive and irrelevant for purposes of this determination.

(h) The Division's proposed findings of fact 57, 59, 60, 71, 321 - 331 consist of excessive quotation of material from documents in the record.

(i) The Division's proposed findings of fact 8, 18, 312, 325 -356, 416 and 489 are not proposed findings of fact, they are defining terms to be used in findings of fact.

(j) The Division's proposed findings of fact 113, 128, 140, 143, 196, 204 - 206, 210, 211, 214 - 216, 223, 231 -237, 240, 244 - 257, 279, 293, 294, 410, 582 - 584 are not relevant to the period in issue.

(k) The Division's proposed findings of fact 11, 12, 15, 17 - 20, 23, 28, 33, 34, 36, 37, 39, 41, 44, 45 - 48, 54, 58, 61 - 69, 72, 75, 76, 84, 91, 95, 99, 100, 101, 110, 127, 129, 142, 145 - 155, 157 - 160, 162, 163, 172, 179, 185, 187 - 192, 194, 195, 197, 199, 200, 207 - 209, 212, 218, 221 - 229, 238, 258, 259, 261, 263, 265, 266, 268, 269, 274, 276 - 278, 280, 282 - 288, 292, 296 - 304, 306 - 309, 311, 313 - 316, 319, 334, 357, 358, 363 - 365, 369, 370, 373 - 379, 381 - 388, 390, 395 - 399, 401, 402, 404 - 409, 411 - 415, 417, 419, 422, 424 - 429, 432 - 441, 443, 444, 446, 448, 451, 452, 460, 465 - 470, 472 - 475, 478 - 480, 482, 488, 492, 495 - 499, 502, 506, 511, 514 - 516, 520, 521, 523 - 526, 528, 533, 536, 539 - 541, 543 - 546, 548, 550, 553, 558 - 563, 567, 570, 576 - 581, 585 - 589, 591 - 605, 610, 612 - 624, 626, 627, 629 and 633 are argumentative or speculative.

(l) The Division's proposed finding of fact 9 is not a proposed finding of fact.

(m) The Division's proposed findings of fact 156 and 157 are not supported by the evidence and constitute conclusions of law.

(n) The Division's proposed findings of fact 171 and 201 are repetitive of other proposed findings of fact.

(o) The Division submitted 15 proposed findings of fact in response to petitioner's motion to have a negative inference drawn from the Division's response to petitioner's subpoena. All of these proposed findings of fact have been incorporated except for proposed finding of fact 14 which has been modified to more accurately reflect the record.

(p) The Division submitted 7 proposed findings of fact in response to petitioner's motion to have witnesses' testimony stricken. The Division's proposed findings of fact 2 and 4 are not reflective of the record. The Division's proposed findings of fact 1, 3, 5, 6 and 8 are argumentative or speculative.

(q) The Division submitted 31 proposed findings of fact in its motion to draw negative inferences from petitioner's lack of compliance with the Division's subpoena. The Division's proposed findings of fact 5 - 13, 15 and 19 are argumentative or speculative.

CONCLUSIONS OF LAW

A. As noted above, both parties made motions at the conclusion of the hearing in this matter. Petitioner's motions are: (1) to have Mr. Pragel's testimony stricken from the record, and (2) to have a negative inference drawn from the Division's response to petitioner's subpoena. The Division's motions are: (1) to have material protected by the attorney-client privilege stricken from the record, and (2) to have a negative inference drawn from petitioner's failure to fully comply with the Division's subpoena. Since all four motions have a bearing upon the evidence and the weight to be given to such evidence, it is necessary to rule on these motions prior to addressing the merits of this case.

B. Petitioner has made a motion to have the testimony of Mr. Pragel, one of the Division's fact witnesses, stricken from the record. Petitioner has made this motion because of Mr. Pragel's presence in the hearing room during the testimony of several of its witnesses in violation of the order that all fact witnesses leave the hearing room until called to testify. Petitioner also asserts that Mr. Pragel violated the exclusion order when he was present during conversations among the Division's counsel regarding witness testimony. Petitioner argues that it has suffered prejudice because Mr. Pragel's testimony is tainted and there is no way of determining whether his testimony was affected or changed by his presence in the hearing room and during the attorneys' conversations. The Division has opposed the motion on several grounds, including that a request was made and granted permitting Mr. Pragel to remain in the hearing room during fact testimony. Next, the Division asserts that even if Mr. Pragel violated the exclusion order, striking the testimony is an inappropriate remedy. Lastly, the Division asserts that Sherwin-Williams cannot demonstrate any prejudice as a result of Mr. Pragel's violation of the exclusion order.

Although it is clear from the record that the Division disobeyed my order on more than one occasion, I am denying petitioner's motion to strike the testimony of Mr. Pragel. Ultimately, the severity of the sanction, including the striking of testimony, turns on two questions. First, whether there was a willful violation by both the Division and the witness, Mr. Pragel. Second, whether petitioner suffered prejudice as a result of the violation. As to the first inquiry, I do not find that the Division and Mr. Pragel acted maliciously or in bad faith when they violated the witness exclusion order. Mr. Pragel had no reason to know that he was not supposed to be in the hearing room while either Ms. Starr or Mr. Panno testified, nor was he supposed to know that he should have left the conference room while the attorneys conversed among themselves. He was, quite understandably, relying on counsel. However, the case of the Division's counsel is more difficult. The witness exclusion order was requested by the Division on the first day of the hearing. Ms. Starr's testimony took place on the second day of the hearing in a small room with limited space. Mr. Pragel, who was sitting in a room on another floor, was summoned to the hearing room by the Division's counsel. On July 15, 1999, Mr. Panno testified about his research and production of documents in order to comply with the subpoena served on petitioner. Mr. Pragel was prepared to testify about his research and production of documents in order to comply with the subpoena served on the Division. Since Mr. Panno testified first, the Division's counsel should have directed Mr. Pragel to leave the room. The Division's counsel also should have been more prudent in where they conducted their conversations. I do not find any evidence or pattern of unprofessional or unethical behavior on the part of Division's counsel. Rather I find that because they were under pressure, the Division's counsel made many mistakes. I do not find their conduct in disobeying the witness exclusion order to be wilful. Ultimately, petitioner has suffered little or no prejudice as a result of this violation.

Although I am denying petitioner's motion to strike the testimony of Mr. Pragel. I will consider Mr. Pragel's testimony in light of the knowledge that he was present during the testimony of several of petitioner's witnesses, and heard snippets of the attorneys' conversations. These facts will be considered in any relevant credibility determinations that I make (***see, Capitol***

Cab Corporation v. Anderson, 194 Misc 21, 85 NYS2d 767, ***affd*** 197 Misc 1035, 100 NYS2d 39).

C. Sherwin-Williams has made a second motion for negative inferences to be drawn from the Division's response to petitioner's subpoena. It makes the motion for negative inferences because there were numerous instances where subpoenaed documents were only found after Sherwin-Williams noted their absence (or the absence of related documents) from the Division's response. Petitioner asserts that since all documentation was not produced, negative inferences are warranted that the Division has not produced material that would indicate that: (1) the transactions between SWIMC and DIMC and Sherwin-Williams were at arm's length; (2) transactions between Sherwin-Williams and SWIMC and DIMC have economic substance; (3) there are companies, including SWIMC and DIMC, that are formed in Delaware to hold intangible property that have valid business purposes for doing so; and (4) the Division did not analyze the facts particular to Sherwin-Williams, SWIMC and DIMC before it asserted that Sherwin-Williams should be forced to file a combined report including SWIMC and DIMC.

The Division asserts that the motion should be denied on several grounds. First, it claims that a thorough search of its records for material covered by petitioner's subpoena was made. While the Division admits that a few documents were not initially provided by it, the Division asserts that those innocent oversights were promptly corrected. It maintains that it has fully complied with petitioner's subpoena and therefore negative inferences are not warranted. Second, the Division asserts that petitioner has failed to identify what documents under the control of the Division have not been provided to petitioner and how those missing documents relate to the combination issue in this proceeding.

Petitioner, as the party seeking the negative inferences against the Division for the Division's failure to comply with petitioner's subpoena, must make a *prima facie* showing that the documents in question actually exist and are under the Division's control (***see, Scaglione v. Victory Memorial Hospital***, 205 AD2d 520, 613 NYS2d 213). The record indicates that the Division's compliance with petitioner's subpoena was indeed sloppy. However, petitioner failed to (i) identify the documents missing from the Division's response to the subpoena, (ii) explain how those missing documents relate to the substantive issues of this case, and (iii) demonstrate that the missing documents existed at the time the subpoena was served and that at said time the documents were within the Division's control. Petitioner has failed to show that a missing document charge is warranted against the Division (***Scaglione v. Victory Memorial Hospital, supra***). Accordingly, petitioner's motion to have negative inferences drawn from the Division's response to petitioner's subpoena is denied.

D. The Division has made a motion to have material protected by the attorney-client privilege stricken from the record. At issue in this motion is the testimony of three of the Division's witnesses, Messrs. Peterson, Maslyn and Tanzman, and two exhibits (exhibits "35" and "36") produced by the Division in response to petitioner's subpoena. The Division asserts that portions of those individuals' testimony and the two exhibits are protected from disclosure under the attorney-client privilege and, accordingly, should be stricken from the record.

The Division objects to the testimony of its witnesses on the grounds that portions of cross-examination of all three individuals exceeded the scope of their direct examination and touched upon matters, including case preparation and trial strategy, covered by the attorney-client privilege. Next, the Division contends that exhibits "35" and "36" are protected by the attorney-client privilege, but were inadvertently disclosed to opposing counsel and should therefore be excluded from the record along with any related testimony.

I have reviewed the arguments on both sides and I must deny the Division's motion to have material protected by the attorney-client privilege stricken from the record.

Exhibit "35" is not a privileged communication. That exhibit consists of an e-mail communication between an auditor and a member of the Office of Counsel concerning the name and address of a fact witness. The e-mail advises Mr. McCann that a package will be forthcoming and discusses conversations with other auditors about subsequent audits of Sherwin-Williams. The name and address of a witness, as well as the knowledge that a package will be forthcoming, is factual information not subject to privilege (***see, Hoopes v. Carota***, 142 AD2d 906, 531 NYS2d 407, ***affd certified question answered***, 74 NY2d 716, 544 NYS2d 808; ***see also, Spectrum Systems International Corporation v. Chemical Bank***, 78 NY2d 371, 575 NYS2d 809). Furthermore, exhibit "35" does not contain a request for legal advice or disclose counsel's legal analysis (***see, Matter of Priest v. Hennessy***, 51 NY2d 62, 431 NYS2d 511; ***Hoopes v. Carota***, ***supra***). Exhibit "36" is not a privileged communication. That exhibit contains communications among employees of the Division, including Mr. Tanzman, as well as the Office of Counsel. Review of the e-mails does reveal requests for legal advice, i.e., the issuance of a subpoena. However, the Division waived the attorney-client privilege that attached to those communications when it placed the subpoena "conspiracy" at issue in this matter on direct examination of Mr. Tanzman (***see, People v. Edney***, 39 NY2d 620, 385 NYS2d 23; ***Jakobleff v. Cerrato, Sweeney and Cohn***, 97 AD2d 834, 468 NYS2d 895). Furthermore, the

Division's witness, Mr. Tanzman, testified on cross-examination about the subpoena "conspiracy," specifically referring to Exhibit "36."

The Division's assertion that it did not waive the attorney-client privilege when exhibits "35" and "36" were turned over to petitioner in response to petitioner's subpoena is rejected. Review of the record indicates that the documents were served upon opposing counsel without reservation of privilege (***see, Bras v. Atlas Construction Corp.***, 153 AD2d 914, 545 NYS2d 723; ***Jakobleff v. Cerrato, Sweeney & Cohn, supra***). Moreover, while Mr. Maslyn did place "post-its" on the privileged documents and so informed Mr. Peterson of that fact when he handed the documents to Mr. Peterson for transmission to the hearing, Mr. Peterson testified that he summarily ripped the "post-its" off the privileged documents and the documents as a whole were delivered to petitioner's counsel. Mr. Peterson testified that he did not take any steps to ensure that privileged documents were not disclosed to Sherwin-Williams. In addition, the Division failed to create a log or record of the privileged documents. The procedure utilized by the Division was clearly not reasonably designed or executed so as to prevent the inadvertent disclosure of exhibits "35" and "36" and therefore supports a finding of waiver (***Bras v. Atlas Construction Corp.***, ***supra***). Accordingly, exhibits "35" and "36" remain a part of the record.

E. Since I have ruled that exhibits "35" and "36" are not privileged material, the testimony of Messrs. Tanzman and Peterson concerning those exhibits should remain part of the record. In addition, since Mr. Tanzman responded to questions on cross-examination regarding exhibits "35" and "36" the privilege was waived and Mr. Tanzman's testimony is admissible. Moreover, since Messrs. Tanzman, Peterson and Maslyn all testified regarding exhibits "35" and "36," the Division's claim that the documents are privileged has been waived (***Merrill Lynch Realty***

Commercial Services, Inc. v. Rudin Management Co., Inc., 94 AD2d 617, 462 NYS2d 16; ***E.B. Metal Industries v. State of New York***, 138 Misc 2d 698, 525 NYS2d 516). Accordingly, any privilege that would have attached to those documents and the testimony of the witnesses has been waived and therefore remains part of the record. The Division's assertion that the portion of Mr. Maslyn's testimony concerning communications he had with the Division's counsel is privileged and should be stricken from the record is rejected. Mr. Maslyn was presented at the hearing for the purpose of testifying with regard to the Division's compliance with petitioner's subpoena and whether privileged documents had been inadvertently disclosed to petitioner's counsel. His responses on direct examination concerned discussions with the Division's counsel regarding screening procedures for privileged documents in connection with responding to petitioner's subpoena. Mr. Maslyn was presented as a fact witness with regard to the screening process used by the Division to ensure that no privileged documents were produced to petitioner's counsel. Therefore, any privilege that otherwise would have attached to his conversations with counsel regarding the inadvertent disclosure of documents was waived.

For all of the foregoing reasons, the Division's motion to have material protected by the attorney-client privilege stricken from the record is denied.

F. The Division has made a second motion to draw negative inferences from petitioner's alleged lack of compliance with the Division's subpoena. It makes the motion to draw negative inferences because petitioner made only a superficial attempt to comply with the Division's subpoena and, as a result, failed to turn over several important documents, including (a) a 1st Amendment to the SWIMC/Sherwin-Williams License Agreement; (b) a 2nd Amendment to the SWIMC/Sherwin-Williams License Agreement; (c) the communications, recommendations and reports between third-party advisors and petitioner that pertain to the creation and capitalization of SWIMC and DIMC; (d) the detailed plans that document petitioner's rationale for transferring intangibles to SWIMC and DIMC; (e) the abstracts of foreign license agreements; and (f) document retention policies for divisions other than petitioner's tax department.

The Division has requested that the following negative inferences be made:

> (1) The 1st Amendment to the SWIMC/Sherwin-Williams License Agreement and the 2nd Amendment to the SWIMC/Sherwin-Williams License Agreement both contained terms and conditions which clearly set forth that petitioner (not SWIMC) is in control of the trademarks;
>
> (2) The communications, recommendations and reports between third party advisors and the petitioner which pertain to the creation and capitalization of SWIMC and DIMC indicate that third party advisors were intricately involved with the establishment of SWIMC and DIMC and recommended the transaction for the sole purpose of reducing franchise taxes; but noted that other purposes may be stated to facilitate justifying the transaction to taxing authorities;
>
> (3) The detailed plans which document the petitioner's rational [sic] for transferring trademarks to SWIMC and DIMC indicate that the sole purpose to undertake the transaction is to reduce franchise taxes, but other purposes may be stated to facilitate justifying the transaction to taxing authorities.
>
> (4) The abstracts of foreign license agreements and the foreign license agreements themselves indicate that materially lower royalty rates were charged to foreign licensees than those that were charged by SWIMC and DIMC for use of the trademarks, or that the foreign licenses are not comparable to SWIMC and DIMC's licenses with petitioner; and,
>
> (5) The draft American Appraisal Associates report contains material and conclusions which differ from those in the final American Appraisal Associates report and the draft American Appraisal Associates report does not support the royalty rates provided in the license agreements between petitioner and SWIMC and DIMC, but rather it supported materially lower royalty rates.

Petitioner asserts that the Division's motion should be denied because (1) it properly complied with the Division's subpoena, (2) the documentation that purportedly was not provided was either cumulative to the voluminous record made or was not shown to exist, and (3) the evidence in the record does not support the negative inferences requested by the Division.

G. While I agree with the Division that the record clearly establishes that petitioner did not make strenuous good faith efforts at complying with the Division's subpoena, the negative inferences requested by the Division are not warranted in this case.

The Division identified a number of documents that petitioner failed to supply in response to the Division's subpoena. The Division has proven that the first and second amendments to the SWIMC/Sherwin-Williams license agreement, the abstracts of foreign license agreements, the draft appraisal report and the "talking list" referenced in Mr. Ivy's testimony did exist when the subpoena was served and that, at that time, those documents were under the control of Sherwin-Williams. Petitioner has offered a reasonable explanation for failing to turn over the abstracts of foreign license agreements. However, it has failed to offer any reasonable explanation for its failure to turn over the first and second amendments to the SWIMC/Sherwin-Williams license agreements, the draft appraisal report and the "talking list." The Division has failed to identify the documents from unnamed third-party advisors that are missing from petitioner's response to the subpoena, demonstrate that the documents existed at the time the subpoena was served and that, at that time, those documents were in the control of Sherwin-Williams. As for the pile of papers referenced in Mr. Ault's testimony, the Division has failed to describe the document with any specificity, demonstrate that the document existed at the time the subpoena was served and that, at that time, that document was in the control of Sherwin-Williams.

Although the Division has proven that the first and second amendments to the SWIMC/ Sherwin-Williams license agreement, the draft appraisal report and the "talking list" were not turned over by petitioner, the record is devoid of any indication that the evidence contained in those four documents would be anything but cumulative to a voluminous record that includes 172 exhibits already entered into the record. Negative inferences are only appropriate where the evidence would be substantial and not merely cumulative (***Oswald v. Heany***, 70 AD2d 653, 416 NYS2d 826, ***see also, Vanigila v. Northgate Homes***, 70 AD2d 806, 525 NYS2d 270). In addition, a negative inference cannot take the place of evidence, it cannot supply a deficiency in the other party's case nor can it be regarded as proof of any essential fact (***see, Laffin v. Ryan***, 4 AD2d 21, 162 NYS2d 730, ***Gleason v. State Tax Commission***, 76 AD2d 1035, 429 NYS2d 314). It is clear from a review of the Division's five requests that they are substitutes for evidence. Therefore, the Division's motion for negative inferences is denied.

H. Article 9-A of the Tax Law imposes a tax on foreign corporations doing business in New York State (Tax Law § 209[1]). In order to properly reflect that tax liability, Tax Law § 211(4) gives the Division the discretion to require or permit corporations subject to New York State tax to file combined reports with certain other corporations. The statute requires that the parent own or control substantially all of the stock of the subsidiary. The statute further limits the Division's discretion by providing that:

> no combined report covering any corporation not a taxpayer shall be required unless the [Division] deems such a report necessary, because of inter-company transactions . . . in order properly to reflect the tax liability (Tax Law § 211[4]).

I. The Division's regulations provide that the Division may require or allow the filing of a combined report where three conditions are met: (1) a stock ownership test (20 NYCRR 6-2.2[a]); (2) a unitary business test (20 NYCRR 6-2.2[b]); and (3) a distortion of income test (20 NYCRR 6-2.3). The distortion of income test provides, in part, that the Division:

> may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers. The activities, business, income or capital of a taxpayer will be *presumed* to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations (20 NYCRR 6-2.3[a][emphasis added]).

The regulation goes on to provide that "[t]he substantial intercorporate transaction requirement may be met where as little as 50 percent of a corporation's receipts or expenses are from one or more qualified activities described in this subdivision" (20 NYCRR 6-2.3[c]).

J. Pursuant to section 6.2-5(a) of the Division's regulations, a corporation not subject to tax in New York State (i.e., not a taxpayer) will not be permitted or required to file on a combined basis with a New York taxpayer corporation or combined group unless the stock ownership test (20 NYCRR 6-2.2[a]) and the unitary business test (20 NYCRR 6-2.2[b]) are met and the Division "determines that inclusion is necessary to properly reflect the tax liability of one or more taxpayers included in the group" because of (1) substantial intercorporate transactions or (2) some agreement or arrangement or transaction which causes the business, income, or capital of any taxpayer to be improperly or inaccurately reflected (20 NYCRR 6-2.5[a]).

Example 1 of 20 NYCRR 6-2.5(a) provides as follows:

> A parent corporation, taxpayer, is the sole owner of a finance subsidiary which is a foreign corporation not subject to tax. The parent manufactures furniture which it sells to independent retail dealers. The parent has an agreement with its finance subsidiary that the subsidiary will directly finance the purchase of the parent's furniture when it is purchased by customers of the independent retail dealers. The subsidiary's income is predominantly derived from financing retail sales of its parent's products. The independent retail dealer arranges the financing for the customer with the subsidiary. The parent and finance subsidiary will be required to file a combined report because of this agreement.

K. For purposes of this matter, there is no dispute that the stock ownership and unitary business requirements have been met. However, petitioner contends that the presumption of distortion requirement has not been met and therefore a combined report is inapplicable here. It asserts that since the goal of 20 NYCRR 6-2.3(a) and (b) is the proper reflection of a taxpayer's income, whether there are substantial intercompany transactions must be determined from the taxpayer's perspective. Petitioner argues that the transactions between it and SWIMC and DIMC are not substantial from petitioner's perspective.

Petitioner's argument is without merit. During 1991, SWIMC received almost all of its royalty income from Sherwin-Williams. DIMC received the vast majority of its royalty income from Sherwin-Williams, with the remainder coming from Dupli-Color, a Sherwin-Williams affiliate. Since there are substantial intercorporate transactions between petitioner and SWIMC and DIMC, a presumption of distortion exists in this case.

L. As explained in ***Matter of Silver King Broadcasting of N.J.*** (Tax Appeals Tribunal, May 9, 1996),

> there are two scenarios for required or permitted combination - presumption and non-presumption. In the presumption cases, the burden is on the taxpayer to show that the intercorporate transactions which give rise to the presumption are arm's-length in order to prove that reporting on a separate basis is a proper reflection of income.
>
> Where the taxpayer rebuts the presumption of distortion . . . and in the non-presumption cases, the Division, in order to require combination, must show why it believes that reporting on a separate basis does not properly reflect income (citations omitted).

The Division contends that it has a presumption and a non-presumption basis for requiring petitioner to file a combined report with its subsidiaries, SWIMC and DIMC.

M. The Division's primary argument is that Sherwin-Williams' trademark assignment and license-back transactions with SWIMC and DIMC are distortive by their very nature and, therefore, that it is unnecessary to look to the presumption of distortion created by the substantial intercompany transactions. It contends that the assignment and license-back transactions at issue here are distortive because of the nature of the asset involved in the transactions, the trademarks. The Division asserts that the resolution of whether the transactions at issue here have economic substance centers around "whether trademarks being used by a parent-licensee that developed them can be 'managed' in any significant sense by its 'passive investment company' licensor-subsidiary, which by statute is restricted in its activities to management or maintenance of its 'investments'." It argues that a trademark is a fragile asset, the value of which depends on how it is being used and that full exploitation of a trademark requires giving it a core meaning, and then always honoring that meaning. The Division maintains that the effect of the trademark assignment and license-back transaction is to separate the trademarks from the knowledge to give them full value. It avers that SWIMC and DIMC do not have the knowledge necessary to make the trademark decisions that they are entitled to make under the license agreements, i.e., monitoring quality control, reviewing advertising, brand product extensions. The Division asserts that if SWIMC and DIMC took their rights as licensors under the License Agreements seriously, the assignment and license-back transactions would destroy value, rather than create it and thus petitioner could not have any rational expectation that the transactions would be profit-enhancing, apart from tax savings. Conversely, the Division argues that if SWIMC and DIMC did not exercise their rights under the License Agreements they only added an extra level of bureaucracy that would not add any value, but had costs associated with it. The Division also argues that there are risks associated with SWIMC and DIMC entering into third-party licensing agreements. It argues that the record clearly establishes that SWIMC and DIMC did not exercise the rights reserved to them under the License Agreements with petitioner and also failed to require petitioner to adhere to the terms of the License Agreements. The Division further argues that

> since SWIMC and DIMC were not acting as owners, and, at best, were only doing the tasks assigned to them by their parent, the substance of this transaction is that petitioner continued to own the marks, and while SWIMC and DIMC might be entitled to some compensation for their performance of their assigned tasks, petitioner's payment of a royalty to them is distortive (Division's brief, p. 91-92).

Lastly, the Division contends that the record establishes that petitioner's motive for entering into the transaction was tax-minimization. In support of this contention, the Division points to the role members of petitioner's tax department had in the planning of the project and the advertising brochures of the promoters of the transaction.

N. Petitioner contends that the assignment of the Marks to SWIMC and DIMC and the license of those Marks to Sherwin-Williams do have economic substance. It asserts that the record shows that management of the Marks improved substantially after SWIMC and DIMC became their owners, there was a significant increase in third-party licensing of the Marks, and investment returns realized by SWIMC and DIMC exceeded those of Sherwin-Williams. Petitioner argues that SWIMC and DIMC were actively involved with managing their Marks. It contends that the record shows that Dr. Puglisi had, on many occasions, denied potential third-party licenses for uses of the Marks that he felt would undermine their value. Petitioner asserts that it is not unreasonable for contracting parties to have different provisions depending on the specific party involved and the nature of the relationship. It also contends that "it is not surprising that inconsequential and nonmaterial variations from certain contractual provisions often go unnoticed or, even if noticed, are not acted upon" (Petitioner's reply brief, p. 19-20). Petitioner maintains that SWIMC and DIMC did everything necessary to ensure that their valuable assets not only maintained their value but increased in value as well. It points out that in addition to handling all maintenance and enforcement of their Marks, SWIMC and DIMC licensed them to Sherwin-Williams and to other parties, and obtained and invested the income derived from those licenses. Petitioner asserts that since SWIMC and DIMC are the legal owners of the Marks, they are entitled to compensation for allowing Sherwin-Williams and other third parties to use those assets. It argues that legal relationships were significantly altered by the transactions, and the fact that they were related transactions does not mean that those altered relationships should not be respected. Petitioner also avers that SWIMC's and DIMC's activities were appropriate to ensure that their purposes were achieved.

Petitioner maintains that there were substantial business reasons for segregating the Marks in SWIMC and DIMC. It asserts that the record clearly establishes that tax promoters were not involved in forming SWIMC and DIMC. Lastly, it points out that the documents which the Division contends support a showing that mystery promoters were involved in the formation of SWIMC and DIMC were all written after the decision to form SWIMC and DIMC was made.

O. Delaware imposes a corporation income tax, but exempts from that tax "[c]orporations whose activities within [Delaware] are confined to the maintenance and management of their intangible assets [including] patents, patent applications, trademarks, trade names and similar type of intangible assets." (30 Del Code Ann § 1902[b][8].)

SWIMC and DIMC were incorporated in Delaware on January 31, 1991. Under their articles of incorporation and bylaws, the activities of SWIMC and DIMC are confined to the maintenance and protection of their intangible investments and therefore qualify for exemption from Delaware corporation income tax. Sherwin-Williams assigned trademarks to SWIMC and DIMC in exchange for stock in both corporations. Sherwin-Williams did not recognize any gain on those exchanges pursuant to IRC § 351. SWIMC and DIMC licensed those Marks back to Sherwin-Williams on a non-exclusive basis.

P. In support of its argument that SWIMC and DIMC served no legitimate business purpose and were formed solely to shield income from state taxes, the Division draws attention to writings which have touted the Delaware trademark corporation as a vehicle to avoid state taxes. The majority of these articles were written after SWIMC and DIMC were formed. I am not persuaded by these articles; taxpayers are free to structure their business affairs as they choose, including the use of any legal corporate structure to minimize state taxes. The assignment of the Marks by petitioner to SWIMC and DIMC and the license back of those Marks to petitioner will not be disregarded for tax purposes if those transactions were effected for legitimate business purposes and were not entered into merely to avoid taxation. (***See, Frank Lyon Company v. U.S.***, 435 US 561, 577, 580, 78-1 US Tax Cas ¶ 9370).

Two factors are considered in determining whether transactions between controlled corporations will be respected: (1) whether the transactions were accomplished for a valid business purpose; and (2) whether they had economic substance (***Frank Lyon Company v. U.S., supra,*** at 572-573, 584; ***see also, Rice's Toyota World, Inc. v. Commissioner***, 752 F2d 89, 91-92, 85-1 US Tax Cas ¶ 9123). The "business purpose" test looks to the taxpayer's motives for entering into the subject transaction, while the "economic substance" test looks to whether there was "a reasonable possibility of profit . . . apart from tax benefits" (***Rice's Toyota World, Inc. v. Commissioner, supra***, at 94-95). A tax avoidance motivation does not preclude respecting a transaction if that was not the only basis for entering into the transaction (***Frank Lyon Company v. U.S., supra***, at 573, 580; ***Rice's Toyota World, Inc. v. Commissioner, supra***, at 96).

Q. The record is clear in establishing that SWIMC and DIMC were formed for valid business purposes and carried out substantial business in their own names. The credible testimony of Messrs. McDonald, Ivy and Ault and the documents in the record clearly establish that Sherwin-Williams formed SWIMC and DIMC for valid business reasons, among them: to hold and manage the Marks; to increase the protection of the Marks; to license the Marks to both related and unrelated entities; to incorporate in a favorable corporate jurisdiction; to avert hostile takeovers; to maximize the return on the stream of royalty income to SWIMC and DIMC through investment in longer-term investments and to have an additional source of financing through the securitization of the royalty income stream to SWIMC and DIMC. SWIMC and DIMC actively managed and protected their respective Marks. They paid for and filed trademark applications and renewals for their respective Marks. SWIMC and DIMC pursued potential infringers of their respective Marks. As president of SWIMC and DIMC, Dr. Puglisi actively managed and protected the Marks. To assist Dr. Puglisi in the management and protection of the Marks, SWIMC and DIMC employed third-party service providers including Duane, Morris, Wood, Emhardt, Naughton, Moriarty and McNett, and Sherwin-Williams. Each company paid for the services provided by the third-party service providers. Subsequent to 1991, SWIMC and DIMC also employed Stewart & Associates and Wade & Santora as third-party service providers as well. During 1991, SWIMC entered into third-party license agreements. Although third-party license inquiries were made to DIMC, no third-party licenses were entered into by DIMC until November of 1992. On a number of occasions, Dr. Puglisi denied third-party licenses for use of the Marks that he felt would undermine their value. Since 1991, SWIMC and DIMC have entered into a significant number of licensing agreements. Dr. Puglisi invested the royalty income that SWIMC and DIMC received from their license agreements in accordance with their respective investment guidelines. The record clearly shows that the directors of SWIMC and DIMC gave Dr. Puglisi full authority and discretion to choose the appropriate security to maximize investment returns, and that over time the investment returns realized by SWIMC and DIMC have been greater than those achieved by Sherwin-Williams.

As for the modification in the License Agreements with respect to the timing of royalty payments by Sherwin-Williams to SWIMC and DIMC, I do not find that those modifications signify that Sherwin-Williams rather than SWIMC and DIMC was in control. The modification in the time to report quarterly sales figures was not changed significantly. Moreover, the record establishes that Sherwin-Williams usually sent SWIMC and DIMC the quarterly sales production reports within 45 days of the end of each quarter. In addition, petitioner began to send SWIMC and DIMC quarterly estimates of sales. Those quarterly estimates of sales allowed Dr. Puglisi to monitor the quality control under the License Agreements with Sherwin-Williams through sales. The record also establishes that subsequent to 1991, SWIMC and DIMC conducted additional quality control activities. Furthermore, the documentation in the record clearly establishes that, during 1991, both SWIMC and DIMC maintained good corporate form and operated not only through Dr. Puglisi, but through regular board of directors meetings.

As for the Division's assertion that unnamed tax promoters were involved in the creation of SWIMC and DIMC, the record does not support that assertion, nor is there any evidence that petitioner relied on "advertising brochures" from tax promoters when it made the decision to form SWIMC and DIMC. The articles to which the Division refers and Stewart & Associates' web page are all post-1991, the year in which SWIMC and DIMC were formed. Petitioner does not deny that tax considerations played a role in its decision to create SWIMC and DIMC. However, there were significant business reasons for the creation of SWIMC and DIMC which cannot be ignored (***Frank Lyon Company v. U.S.***, ***supra***).

In sum, the assignment of the trademarks by Sherwin-Williams to SWIMC and DIMC and the license back of those trademarks to Sherwin-Williams were accomplished for valid business purposes, were characterized by economic substance, and were not motivated solely by tax avoidance.

R. The Division asserts that the licensing agreements between Sherwin-Williams and SWIMC and DIMC are anomalous. It argues that as a result of the assignment and license-back transaction, SWIMC and DIMC had trademarks, but they did not have core businesses in which they used the trademarks to sell branded products. The Division contends that this type of licensing situation is completely different from the ususal licensing situation. It maintains that in the usual licensing situation, the licensor will have a core business and the licensor continues to add value to the trademarks by using them to sell branded products. The Division argues that SWIMC and DIMC are contributing far less to maintaining and enhancing the value of the trademarks that they license to petitioner than would normal licensors.

Contrary to the Division's contention, the Licensing Agreements between petitioner and SWIMC and DIMC are not anomalous. Trademarks can exist unrelated from a core business. Indeed, Mr. Bromberg, the Division's trademark expert, had first hand experience with a company that owned trademarks, but did not have any ongoing business. Trademarks have increasingly become recognized as property that exists separate from the business. There are no normal or abnormal licensing arrangements, just different types depending upon the needs of the parties.

S. The License Agreements between Sherwin-Williams and SWIMC and DIMC require Sherwin-Williams to pay royalties for its use of the trademarks. The royalty rates set forth in the License Agreements were determined by American Appraisal Associates ("AAA") when that company determined the fair market value of petitioner's domestic trademarks and trade names. AAA set forth its valuation study in an appraisal report.

The Division contends that the AAA appraisal report was fundamentally flawed, and therefore determined royalty rates that were above the arm's-length amount. It asserts that AAA's application of the 25% to 33⅓% profit split "rule of thumb" is not in accordance with the 1994 regulations to IRC § 482. The Division claims that those regulations "do not countenance the use of any 'rules of thumb' in determining what constitutes an arm's-length royalty rate" (Division's brief, p. 114). It argues that AAA made a fundamental error in applying the 25% to 33⅓% profit split rule of thumb: AAA applied the split to operating profits rather than residual profits arising from the use of the trademark, leading to inappropriately high royalty rates. The Division, through Dr. Shapiro, claims that AAA's valuation of the Marks was too high. It bases that claim on Dr. Shapiro's opinion that the Marks could not have accounted for over 76 percent of petitioner's intangible assets and that AAA "knew" that the royalty rates were excessive and therefore inflated the discount rate it applied to determine the present value of the royalty income streams based on the royalty rates determined in the report.

Petitioner asserts that the AAA appraisal report determined the fair market value of the Marks and arm's-length royalty rates. It points out that the AAA appraisal report was prepared in 1991, long before the 1994 section 482 regulations were issued. Petitioner contends that AAA's use of the 25% to 33⅓% profit split rule of thumb on operating profits or net profits is correct. It argues that the Encyclopedia of Patent Practice, other economists, courts and the Treasury Regulations all support AAA's view. As for the claim that AAA's valuation was too high, petitioner asserts that no support was presented to corroborate Dr. Shapiro's opinion that the other intangibles must have been worth more than 25 percent of its intangible assets.

T. After review of the appraisal report, the credible testimony of Mr. Billovits, and the other evidence in the record, I find that the royalty rates determined by AAA were appropriate and arm's-length. As petitioner correctly pointed out, the AAA appraisal was prepared long before the 1994 Treasury Regulations were enacted. With respect to AAA's application of the 25% to 33⅓% profit split to operating profits rather than residual profits, I find that AAA correctly applied the rule of thumb. The Division's argument that when the discount rate computed by Dr. Shapiro is used to calculate the present value of the trademarks the royalty rates become too high, is rejected. I do not accept Dr. Shapiro's opinion that trademarks account for only a fraction of the intangible assets of a corporation. The other intangible assets which Dr. Shapiro identified - - multiple distribution channels, ability to maintain quality control and the ability to adapt to a changing marketplace are not even considered intangibles under the 1994 section 482 Treasury Regulations. Moreover, Dr. Shapiro failed to perform a valuation of the other intangibles.

U. As noted above, the presumption of distortion exists in this matter because of the substantial intercorporate transactions between petitioner and SWIMC and DIMC. The presumption of distortion is one that can be rebutted by the taxpayer by showing that the transactions between the corporations are at arm's length (***see, Matter of USV Pharm. Corp.***, Tax Appeals Tribunal, July 16, 1992 [use of Federal section 482 adjustments appropriate to show arm's-length pricing]; ***Matter of Standard Mfg. Co.,*** Tax Appeals Tribunal, February 6, 1992; ***see also, Matter of Tropicana Products Sales, Inc.***, Tax Appeals Tribunal, June 12, 2000; ***Matter of Sears, Roebuck & Co.***, Tax Appeals Tribunal, April 28, 1994; ***Matter of Campbell Sales Co.***, Tax Appeals Tribunal, December 2, 1993 [the Tribunal will apply section 482 principles in the absence of Federal section 482 adjustments]).

V. As noted previously, in an effort to rebut the presumption of distortion, a transfer pricing report was prepared by Grant Thornton which sought to analyze the intercompany transactions between SWIMC and DIMC in accordance with the regulations promulgated under Internal Revenue Code § 482.

The Grant Thornton report applied the final section 482 regulations issued in 1994. The Grant Thornton report sought to determine whether the royalty rates charged by SWIMC and DIMC were arm's length rates by using the comparable profits method ("CPM"). This method "evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances" (Treas Reg § 1.482-5[a]).

An arm's length result is determined by the amount of operating profit that the tested party would have earned on the controlled transaction if its profit level indicators were equal to that of an uncontrolled comparable (Treas Reg § 1.482-5[b][1]).

The CPM requires a selection of comparable uncontrolled transactions or entities. Treas Reg § 1.482-1(d) sets forth the factors which affect comparability under a particular method. These factors include: functions, contractual terms, risks, economic conditions, and property or services. Treas Reg § 1.482-1(e)(2)(ii), which sets forth the criteria for the selection of comparables, provides as follows:

> Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

Treas Reg § 1.482-5(c) sets forth the degree of comparability required under the CPM. The CPM "compares the profitability of the tested party, measured by a profit level indicator (generally based on operating profit) to the profitability of uncontrolled taxpayers in similar circumstances" (Treas Reg § 1.482-5[c][2][i]). Comparability under the CPM "is particularly dependent on resources employed and risks assumed" (Treas Reg § 1.482-5[c][2][ii]). The degree of functional comparability required to obtain a reliable result under the CPM is "generally less than that required under the resale price or cost plus methods" (Treas Reg § 1.482-5[c][2][ii]). The CPM is not as dependent on product similarity as the resale price or cost plus method "because operating profit usually is less sensitive than gross profit to product differences" (Treas Reg § 1.482-5[c][2][iii]).

Once comparables are selected, the CPM provides that if there are differences between the tested party and the comparables that would materially affect the profits determined under the profit level indicator, adjustments should be made. Such adjustments include adjusting the operating profits for differences in inventory, accounts receivable and accounts payable (***see,*** Treas Reg § 1.482-5[c][2][iv]). The arm's length range will consist of the financial results of all the uncontrolled comparables if all material differences between the tested party and the uncontrolled comparables have been identified and adjustments have been made to eliminate the effect of each such difference (Treas Reg § 1.482-1[e][2][iii][A]). Where, however, there may be unascertainable differences or uncorrectable differences between the tested party and the comparable parties, the reliability of the results of an analysis must be increased by adjusting the range of results through the application of a valid statistical method, such as the interquartile range, which is defined to encompass results between the 25th percentile and the 75th percentile of the observations derived from uncontrolled comparables (***see***, Treas Reg § 1.482-1[e][2][iii][B]). Grant Thornton used the interquartile range in its CPM analysis.

Once comparables have been selected and appropriate adjustments made, the CPM requires that comparable operating profits be derived from a single profit level indicator (Treas Reg § 1.482-5[b][3]). Profit level indicators are "ratios that measure relationships between profits and costs incurred or resources employed" (Treas Reg § 1.482-5[b][4]).

Among the profit level indicators set forth in the regulations are the rate of return of capital employed (defined as the ratio of operating profit to operating assets) and various financial ratios including the ratio of operating profit to sales (Treas Reg § 1.482-5[b][4][i], 4[ii]). Grant Thornton used the ratio of operating profit to sales and the fully-loaded cost plus ratio, which is the ratio of operating profit to total cost (cost of goods sold plus operating expenses) in its CPM analysis. In its transfer pricing report, Grant Thornton noted that the fully-loaded cost plus ratio is not specifically mentioned in the Internal Revenue Code § 482 regulations, but is frequently used by practitioners as a reliable gauge to evaluate the routine profit levels of manufacturing and service companies.

W. For purposes of its CPM analysis, Grant Thornton determined the tested parties to be Sherwin-Williams operating divisions - - Automotive, Consumer, Specialty, Paint Stores and Transportation. Grant Thornton performed a separate CPM analysis of each of the operating divisions. The profit level indicator used for the manufacturing and the transportation comparables was the fully-loaded cost plus ratio. For the Paint Stores Division's comparables, Grant Thornton used the ratio of operating profit to sales.

Upon review of the Grant Thornton CPM analysis for each of petitioner's operating division's, the testimony of Mr. Hasenwinkle in support thereof and the relevant regulations as noted, it is concluded that the CPM analysis selected uncontrolled taxpayers that were comparable within the standards of Treas Reg § 1.482-5(c)(2)(ii) and (iii); that appropriate adjustments to the comparables were made pursuant to Treas Reg § 1.482-5(c)(2)(iv); that the arm's length range under the CPM analysis was the interquartile range of all operating profits derived from the comparable parties (Treas Reg § 1.482-1[e][2][iii][B]); that the profit level indicators were appropriately applied (Treas Reg § 1.482-5[b][4]); that the application of such profit level indicators revealed that each of the operating division's profit level indicators fell within the interquartile range and therefore, by implication, the royalty rates at issue also fell within an arm's-length range.

X. The Division has raised a number of objections to Grant Thornton's CPM analysis. I will address each of the objections and explain why it is incorrect or does not affect the transfer pricing study in a significant way. First, the Division questions the method used by Grant Thornton in allocating the Corporate Division's sales and expenses to each of the operating divisions. Specifically, it questions Grant Thornton's decision to include the financial results from non-royalty bearing sales in the divisional financial data it analyzed, and Grant Thornton's method of allocating depreciation through the use of a sales ratio. In order to calculate the net-of-royalty operating profit of each of the five operating divisions, as if it was a stand-alone entity, Grant Thornton had to allocate to each division a portion of petitioner's Corporate Division's sales and expenses because the operating assets used by the various operating divisions reside in the Corporate Division. I find that the allocations of the Corporate Division's sales and expenses by Grant Thornton were appropriate and properly made. The best method rule states that the "arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result (Treas Reg § 1.482-1[c][1]). Whether a method provides the most reliable measure of an arm's length result "also depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions" (Treas Reg § 1.482-1[c][2][ii]). The allocations made by Grant Thornton increased the reliability of the results obtained under the CPM analysis.

Next, the Division questions Grant Thornton's exclusion of comparable companies that have significant intangibles. It argues that Grant Thornton failed to take into account other valuable intangibles, identified by Dr. Shapiro, that contribute to profitability. I find that Grant Thornton properly excluded companies with valuable intangibles. After analyzing the functions of Sherwin-Williams, SWIMC and DIMC, Grant Thornton determined that the appropriate tested parties were petitioner's operating divisions. It then determined that the CPM was the best method to use in its analysis of the license of the Marks by SWIMC and DIMC to petitioner. Treas Reg § 1.482-5(b)(2)(i) states that "the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables." Since the operating divisions license the Marks from SWIMC and DIMC, the comparable companies should not own any valuable intangible property as well. Furthermore, the other intangible assets that the Division contends should be taken into account when determining the choice of comparables are not considered intangibles under the section 482 regulations.

The Division asserts that another serious shortcoming in Grant Thornton's report is its apparent arbitrariness in choosing comparables. It argues that Grant Thornton chose comparable companies that performed a range of activities and not just the manufacturing of coatings. Specifically, it points out Grant Thornton's choices of PPG and Grow Group. In addition, with respect to these comparables, the Division contends that Grant Thornton failed to properly apply the comparables' financial data, specifically with respect to their use as comparables to the Automotive Division. It asserts that the annual reports provide information about their business segments that relate to the tested party's relevant business activity. I have reviewed the annual reports of both companies and find them to be comparable companies. The Division is correct that Grant Thornton should have used the business segment data related to PPG's coatings and resins segment and Grow Group's coatings and chemicals segment in its Automotive Division CPM analysis. When the financial data for PPG's coatings and resin segment is used, the change in the three-year unadjusted operating profit to total cost ratio is *de minimus*. Use of Grow Group's coatings and chemicals segment financial data does change its three-year unadjusted operating profit to total cost ratio significantly. However, I have recalculated the Automotive Division's interquartile range using the figures supplied by the Division and the Automotive Division's PLI still falls within the interquartile range. In addition to using Grow Group as a comparable for the Automotive Division CPM analysis, it was used for the CPM analysis performed for the Consumer and Specialty divisions. After reviewing the annual reports for Grow Group and petitioner, I find that Grant Thornton correctly used the financial data for Grow Group in the CPM analysis of the Consumer and Specialty divisions. The Division also contends that Grant Thornton should have used the financial data from Ferro's coatings, colors and ceramics segment rather than the financial data of the company as a whole in the Consumer Division's CPM analysis. My review of the annual reports of Ferro and petitioner indicate that Grant Thornton used the correct financial data.

The Division claims that Grant Thornton's decision to use some of the comparables for more than one division's CPM analysis is a major problem. I do not find it so. My review of the companies that were used as comparables for more than one CPM analysis indicates that they were appropriate choices for each CPM analysis for which they were chosen. Moreover, it must be remembered that the CPM emphasizes broad similarity in terms of products, functions, assets employed, and risks assumed while comparing financial returns (***see***, Treas Reg § 1.482-5[c][2]).

The Division asserts that Grant Thornton made a number of errors in the CPM analysis it performed for the Automotive Division. It claims that because Grant Thornton's functional analysis failed to uncover that petitioner had automotive branches, Grant Thornton chose comparables without regard to whether they had a retail aspect. The Division argues that PPG and Lilly, not only do not have any retail operations, but in fact show sales to original equipment manufacturers. It points out that selling to original equipment manufacturers is only a secondary business for the Automotive Division according to Grant Thornton's own functional analysis of that division. It questions the appropriateness of the choice of Lilly, since Lilly's and the Automotive Division's primary business were completely different in their economics. I do not find that Grant Thornton erred in its choice of comparables for the Automotive Division because it failed to take into account the fact that the Automotive Division markets its products through automotive branches and sales representatives. Mr. Ivy testified that petitioner did not record data on sales made by those automotive branches. Since information is not available on that aspect of the Automotive Division's functions, it is impossible to determine what impact the use of the automotive branches as sales channels has on profit. Moreover, it must be noted that Grant Thornton, in an effort to increase the reliability of the results, used the interquartile range (***see***, Treas Reg § 1.482-1[e][2][iii][B]). In addition, I do not find either PPG or Lilly to be inappropriate choices as Automotive Division comparables. In its Annual Report, PPG identifies petitioner as one of its major competitors in the supply of coating products for automotive manufacturing and repair. In addition to supplying automotive finishes to the automobile original equipment, PPG supplies finishes to the automotive aftermarket. According to Lilly's Annual Report, its automotive finishes are distributed mainly to repair shops and fleet users.

The Division contends that the Paint Stores Division's CPM analysis is seriously flawed. It argues that Grant Thornton's determination to use two different sets of comparables, a retail comparable set and a wholesale comparable set and then to compare the Paint Stores Division's PLI to a weighted average of the two sets of comparables was based solely on internal data that Mr. Hasenwinkle did not verify. The Division asserts that use of internal data is frowned upon by the 1994 regulations. It also argues that Grant Thornton chose comparables without regard to the size or geographic scope of the comparable companies' operations, both of which factors are comparability considerations under the 1994 regulations. The Division points out that three of the four wholesale comparable companies are regional companies, with much smaller volumes of sales. It argues that the financial results of the three smaller and geographically-limited wholesale comparables used by Grant Thornton may not be comparable to the large-volume, nation-wide operations of the Paint Stores Division. The Division supports this argument by pointing out that Dr. Shapiro opined that a regional distribution company might not fully take advantage of the economies of scale compared to a national distribution company.

The Division's arguments are without merit. Mr. Hasenwinkle testified that he confirmed his conversations with petitioner's personnel about the composition of sales (wholesale and retail) made by the Paint Stores Division by review of petitioner's Form 10-K. I find his testimony to be credible. Since 80 percent of the paint stores' sales were made to the wholesale level and 20 percent were made to the retail level, it was entirely appropriate to use the weighted average of the two sets of comparables to determine whether the Paint Stores Division's operating profits fell within the interquartile range. Treas Reg § 1.482-1(d)(4)(ii)(A) defines a geographical market as "any geographic area in which the economic conditions for the relevant product or service are substantially the same, and may include multiple countries, depending on the economic conditions." For purposes of the 1994 regulations, the United States is considered one market. My review of the combined set of wholesale and retail companies indicates that nearly every geographic region of the United States is represented. Those comparable companies and the Paint Stores Division are exposed to substantially the same economic conditions. It is noted that Grant Thornton used the three-year average to evaluate the arm's-length nature of the intercompany transactions for the Paint Stores Division. Treas Reg § 1.482-1(f)(2)(iii)(B) advocates this approach to mitigate the effect of year-to-year variations in a company's profitability due to differences in economic conditions, such as industry business cycles and/or product life cycles. I do not believe that the smaller sales volume of the wholesale regional companies affects the reliability of Grant Thornton's choice of comparables. My review of the wholesale comparables indicates that these companies were not small "mom and pop" operations. Rather they were enterprises that successfully competed against national companies by offering a wide range of building materials to the wholesale market. The Division also contends that Grant Thornton incorrectly included the Canadian Paint Stores and the International (Domestic) Division sales in the net sales figure for the Paint Stores Division. It argues that it was improper to include those sales because petitioner only transferred its domestic trademarks to SWIMC and DIMC and there is no evidence that either the Canadian Paint Stores or the International (Domestic) Division used SWIMC and DIMC trademarks and paid any royalties to those entities. I have reviewed petitioner's annual reports that are part of the record and I find that the Canadian Paint Stores and the International (Domestic) Division did in fact sell and distribute products manufactured in the United States. Therefore, Grant Thornton properly included the Canadian Paint Stores and the International (Domestic) divisions sales in the Paint Stores Division's net sales figure.

Grant Thornton's CPM analysis failed to annualize the eleven months of actual royalties paid by petitioner to SWIMC and DIMC for the licensing of certain Marks, when it applied those royalty payments to the data for the years 1989 and 1990 for the operating divisions' financial analyses. However, the effects of annualizing the royalty rates for the divisions is *de minimus.* I do not find that each division's net-of-royalty operating profits for 1989 and 1990 would materially change.

Y. As noted previously, petitioner also submitted an arm's length study prepared by Mr Genetelli which sought to analyze the intercompany transactions between Sherwin-Williams and SWIMC and DIMC in accordance with the regulations promulgated under Internal Revenue Code § 482.

The Genetelli study applied the final 482 regulations issued in 1994. The Genetelli study sought to determine whether the royalty rates charged by SWIMC and DIMC were arm's length by using the CPM and the profit split method ("PSM"). Under the CPM, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on the controlled transaction if its profit level indicators were equal to that of an uncontrolled comparable (comparable operating profit). Comparable operating profit is calculated "by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available" (Treas Reg § 1.482-5[b][1]).

Mr. Genetelli determined petitioner to be the appropriate tested party. Five companies were determined to be comparable to petitioner. For purposes of applying the CPM, as well as the PSM, research and development costs were added back to the operating profit figures of petitioner and those of the comparables. Two profit level indicators were used in the Genetelli CPM study, operating profits PLI ("operating profits as a percentage of sales") and rate of return on capital employed. Adjustments were made to the operating profits of the comparable companies for small differences between petitioner and the comparable companies. Mr. Genetelli determined that because these adjustments were made, the arm's length range was the entire range of constructive operating profits.

Z. A review of Mr. Genetelli's CPM analysis and the pertinent Treasury Regulations compels the rejection of said analysis as proof that the royalty rates at issue fell within an arm's length range.

As the Division correctly noted, Mr. Genetelli in his calculation of petitioner's operating profits for purposes of the CPM analysis made several errors. First, Mr. Genetelli failed to subtract the amount of petitioner's royalty payments from the unadjusted operating profit figure used for petitioner. This must be done because the unadjusted operating profit figure taken from petitioner's Annual Report does not include any intercompany expense such as the payment of a royalty by petitioner to SWIMC and DIMC. The CPM seeks to determine whether an intercompany transaction is at arm's length by comparing the financial results of the tested party to those of comparable companies after taking into account the transaction in question (Treas

Reg § 1.482-5[b][1]). Second, Mr. Genetelli added back research and development expense for the year without adding any amount for amortization of research and development expense incurred in pre-1991 years that benefits operating income in 1991.

The choice of comparables is flawed as well in the Genetelli CPM analysis. The analysis uses some manufacturing companies that do not sell their products through company-owned stores. Sherwin-Williams' Paint Stores Division accounts for a large portion of petitioner's sales and profits. Mr. Genetelli made adjustments to the operating profits of the comparable companies for small differences in inventory, accounts payable and accounts receivable. He then determined that because these adjustments were made, the arm's length range was the entire range of constructive operating profits. To use the arm's-length range, information about the controlled transaction and the uncontrolled comparables must be sufficiently complete that all material differences likely have been identified, the definite and reasonably ascertainable effects on price or profit have been quantified and all appropriate adjustments have been made (Treas Reg §1.482-1[e][2][iii]). Mr. Genetelli's failure to account for differences in distribution functions reduces the reliability of the arm's-length range.

AA. As noted, Mr. Genetelli also performed the profit split method of analysis. This method "evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss" (Treas Reg § 1.482-6[a]). Treas Reg § 1.482-6(c) provides that there are two allocation methods under the PSM: the comparable profit split and the residual profit split. Under the comparable profit split method, "each uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity" (Treas Reg § 1.482-6[c][2][i]). Under the residual profit split method, the combined operating profit or loss from the relevant business activity is allocated among the controlled taxpayers following a two-step process (Treas Reg § 1.482-6[c][3][i]). The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity. The residual profit is then "divided among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution" (Treas Reg § 1.482-6[c][3][A], [3][B]). In his study, Mr. Genetelli states that the PSM determines the appropriate royalty by dividing the profits between petitioner and SWIMC and DIMC.

For purposes of the PSM, Mr. Genetelli applied a widely recognized economic principle that the royalty paid to licensors is generally between 25% and 33% of the profit attributable to the employment of the subject intangibles. Mr. Genetelli applied the 25% to 33% range to the adjusted operating profits figures of each of the comparables and petitioner. He then determined the arm's length range of royalty rates for the five comparable companies.

BB. A review of the Genetelli PSM analysis and the relevant Treasury Regulations compels rejection of said analysis as proof that the royalty rates at issue fell within an arm's length range.

Mr. Genetelli did not apply either of the two profit split methodologies permitted under the PSM, the comparable profit split method or the residual profit split method. Rather, he applied a widely recognized economic principle that divides the operating profit of the licensee and licensor, with a 25 percent to 33 percent share of operating profits going to the licensor in the form of royalty and the remainder being retained by the licensee. Although not explicitly stated in his study, it appears that Mr. Genetelli applied what would be considered an unspecified method under Treas Reg § 1.482-4(d)(1). That regulation states: "that the reliability of a method will be affected by the reliability of the data and the assumptions used to apply the method, including any projections used" (Treas Reg § 1.482-4[d][1]).

I find that Mr. Genetelli made a number of errors in his calculation of the adjusted operating profit figure for petitioner. First, Mr. Genetelli calculated petitioner's adjusted operating profit by taking the company's unadjusted operating profits plus the royalties paid for 1991, plus research and development costs. The royalties were added back to the unadjusted operating profits to arrive at the gross figure to be apportioned between the licensor and licensee, in order to determine what portion of the profit represents royalties due to the licensor. The unadjusted operating profit figure used by Mr. Genetelli is already on a pre-royalty basis because he used the consolidated income figures from petitioner's Annual Report. Second, Mr. Genetelli added back the research and development expense for the year without adding any amount for amortization of research and development expense incurred in pre-1991 years that benefits operating income in 1991.

CC. Treas Reg § 1.482-2(a) provides rules for determining arm's-length interest on loans between controlled entities. The regulations require that the loans constitute bona fide indebtedness (Treas Reg § 1.482-2[a][1][ii]) and define arm's-length interest rate generally as follows:

> For purposes of section 482 . . . an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties

> under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

The Grant Thornton transfer pricing report establishes that the interest rate on the loan made by SWIMC to Sherwin-Williams was identical to the interest rate on a loan between Sherwin-Williams and an independent financial institution, National City Bank. The report thus indicates that the loan was made at arm's length.

The Genetelli arm's length study also supports petitioner's position that the interest rate SWIMC charged Sherwin-Williams was an arm's length rate.

DD. Treas Reg § 1.482-2(b) provides rules concerning the pricing for intercompany services. This regulation gives the Internal Revenue Service the right to make an adjustment to a taxpayer's income or expenses if one member of a group of related entities has either not charged for services that it provided to, or on behalf of, another related party, or if it charged a price that was not arm's-length (Treas Reg § 1.482-2[b][1]). The regulations apply two tests to cases where services have been provided to a related party: (i) the benefits test, which determines whether or not a transfer price must be charged for the service, and if a price should be charged (Treas Reg § 1.482-2[b][2]); (ii) the integral test, which determines whether or not the amount charged must provide a profit markup to an entity that provides the service (Treas Reg § 1.482-2[b][7]).

Under the benefits test, a transfer price must be charged whenever an entity is performing services that either actually provide a benefit to the related party, or were intended to do so (Treas Reg § 1.482-2[b][2][i]). However, intercompany charges cannot be made for services that are merely duplicative in nature and that the related party already performs for itself (Treas Reg § 1.482-2[b][2][ii]).

The integral test determines whether or not a profit component must be explicitly included in the amount that is charged for a service that passed the benefits test. A service that one related party provides for another will be considered “integral” in any of three situations:
(1) The renderer or the recipient of the service is engaged in the trade or business of providing similar services to one or more unrelated parties (Treas Reg § 1.482-2[b][7][i]). (2) The provision of the services to one or more unrelated entities is one of the “principal” business activities of the renderer, where a principal business activity is defined to constitute 25 percent of the total operating costs of the provider or recipient of the services (Treas Reg § 1.482-2[b][7][ii]). At the taxpayer’s election, the 25 percent test may be applied on a consolidated basis (Treas Reg § 1.482-2[b][7][iv]). (3) The entity that provided the services is (i) peculiarly capable of rendering the service, (ii) the services are a principal element of the recipient’s operations, and (iii) the value of the services “substantially” exceeds the costs or deductions that were incurred in providing the services to the related party (e.g., where the provider of a service has a special reputation or skill, influential customer relationships, or relevant intangible property (Treas Reg § 1.482-2[b][7][iii]).

For purposes of Treas Reg § 1.482-2(b), an arm’s length charge for services rendered is “the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts” (Treas Reg § 1.482-2[b][3]). If the intercompany services are shown to provide a benefit to the recipient, and are determined not to be an integral part of the business activities of either the recipient or the provider of the service, the arm's length charge will be deemed equal to the costs or deductions incurred with respect to such services by the provider of such services unless the taxpayer establishes a more appropriate price that would have been charged for the same or similar services in independent transactions between unrelated parties under similar circumstances considering all relevant factors (Treas Reg § 1.482-2[b][3]). When the amount of an arm's length charge for services is determined with reference to the cost or deductions with respect to such services, the intercompany service charge must "take into account on some reasonable basis all the costs or deductions which are directly or indirectly related to the service performed" (Treas Reg § 1.482-2[b][4][i]). Direct costs or deductions are related to the provision of the service (Treas Reg § 1.482-2[b][4][ii]). Indirect costs or deductions are defined as "those which are not specifically identified with a particular activity or service but which relate to the direct costs" (Treas Reg § 1.482-2[b][4][iii]). Indirect costs include overhead expenses such as utilities, depreciation, clerical and supervisory staff compensation, and allocated general, administrative, and support costs (***see,*** Treas Reg § 1.482-2[b][4][iii]). When services are determined to be integral to the business activities of the provider or the recipient of the services, the charge for the services must equal the fully-absorbed cost of the services plus a profit markup equal to that which would have been charged for the same or similar services in transactions between unrelated parties under similar circumstances, i.e., an arm's length charge (Treas Reg § 1.482-2[b][1]).

EE. The Grant Thornton transfer pricing report establishes that the fees charged by Sherwin-Williams to SWIMC and DIMC for its provision of trademark and licensing legal services fell within the range of rates charged by independent legal practioners for the performance of trademark and licensing services in the Cleveland/Akron geographical area. The report thus indicates that the charges made by Sherwin-Williams for the provision of intercompany trademark services were made at arm's length.

The Genetelli arm's length study also supports petitioner's position that the rates charged by Sherwin-Williams for the trademark services performed for SWIMC and DIMC were at arm's length.

FF. The separate accounting analysis provides little support to petitioner's position herein. There were inconsistencies raised by the Division that Mr. Genetelli failed to adequately address.

GG. The foregoing Conclusions of Law establish the following: (1) the Grant Thornton CPM analysis establishes that the royalties paid by Sherwin-Williams to SWIMC and DIMC during the period in issue were arm's length; (2) the Grant Thornton interest rate analysis establishes that the interest rate charged by SWIMC on its loan to Sherwin-Williams was arm's length; (3) the Grant Thornton intercompany services analysis establishes that the rates charged by Sherwin Williams for the trademark services performed for SWIMC and DIMC were at arm's length; (4) since the royalties, interest rate on the intercompany loan and the charges for intercompany trademark services were at arm's length, petitioner has rebutted the presumption of distortion arising from the existence of a unitary business and substantial intercorporate transactions; (4) the Division has not established the existence of distortion in connection with the royalties, the interest rate or the charges for the intercompany services; and (5) accordingly, the Division may not require petitioner to file a combined corporation franchise tax report with SWIMC and DIMC.

HH. The petition of The Sherwin-Williams Company is granted to the extent of Conclusion of Law "GG"; the Division of Taxation is directed to modify the Notice of Deficiency accordingly, but in all other respects the petition is denied.

DATED: Troy, New York
June 7, 2001

/s/Winifred M. Maloney
ADMINISTRATIVE LAW JUDGE